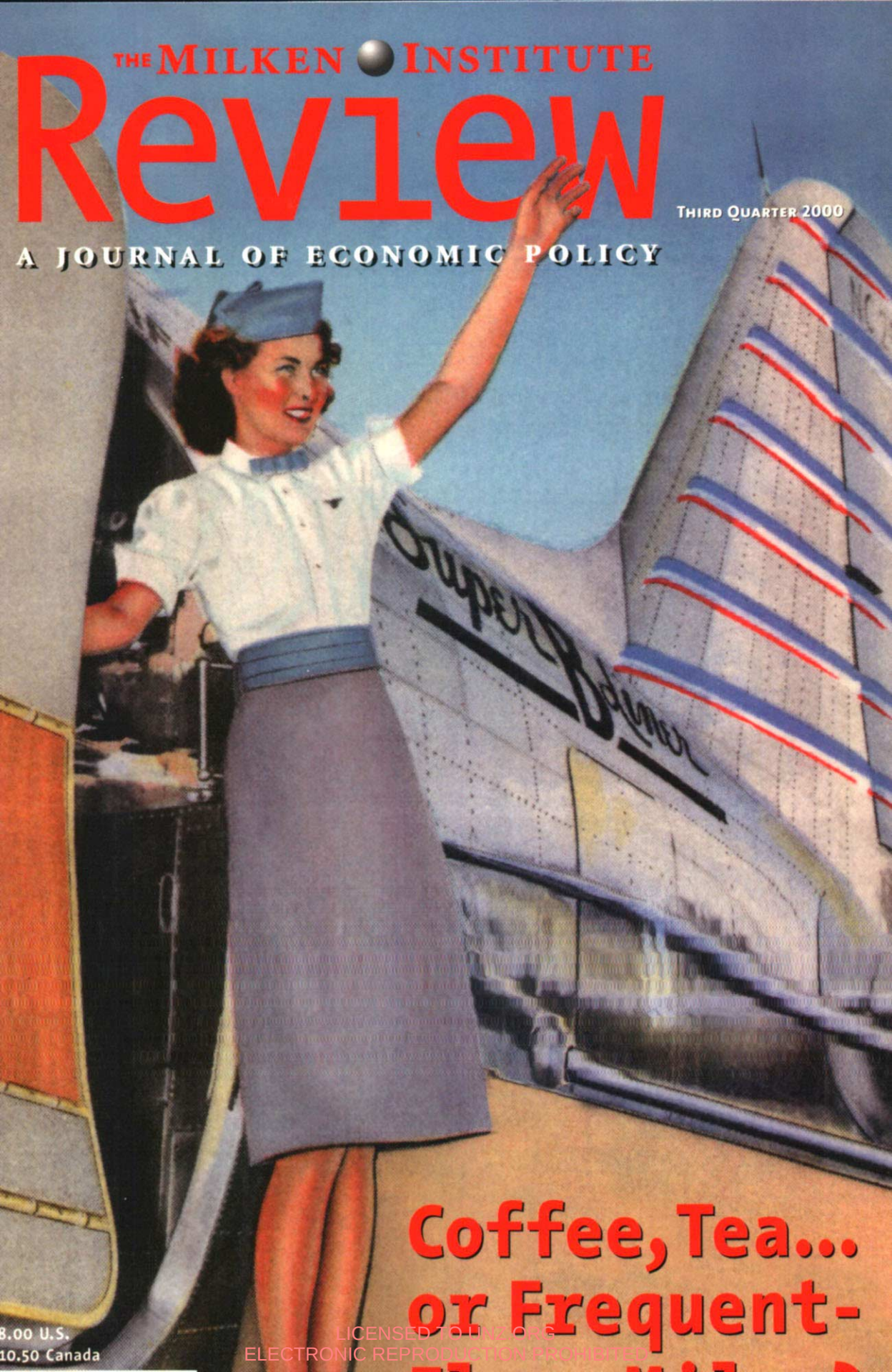
THE MILKEN INSTITUTE

Review

THIRD QUARTER 2000

A JOURNAL OF ECONOMIC POLICY



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PUBLISHER

Joel Kurtzman

EDITOR IN CHIEF

Peter Passell

ART DIRECTOR

Joannah Ralston, Insight Design

ASSOCIATE ART DIRECTOR

Elise Whittemore-Hill

MANAGING EDITOR

Larry Yu

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Requests for additional copies should be sent directly to:

The Milken Institute
The Milken Institute Review
1250 Fourth Street, Second Floor
Santa Monica, CA 90401-1353
310-998-2600 telephone
310-998-2627 fax
info@milkeninstitute.org
www.milkeninstitute.org

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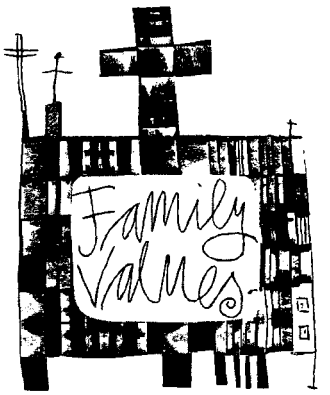

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We may not be young any longer – this is the seventh issue of *The Milken Institute Review*. But, thanks to our fabulous design team, the magazine is looking better and better. And once again, we hope to provoke you with views on economic policy that are anything but old.

Marcus Noland, a senior fellow at the Institute for International Economics in Washington, writes about globalism's critics. The demonstrations keyed to the spring meetings of the World Bank and the International Monetary Fund there got all the attention. But Noland thinks that something called the International Financial Institutions Advisory Commission, headed by Prof. Allan Meltzer of Carnegie Mellon University, posed a bigger threat to the establishment. "While the street protesters' concerns appeared at times to be only tenuously related to the activities of the two Bretton Woods institutions," writes Noland, "Meltzer and the majority of his fellow commissioners were proposing the most radical restructuring of the international financial institutions in half a century."

Steve Morrison of Northeastern University and **Clifford Winston** of the Brookings Institution offer their two cents' worth on the economics and politics of the airline industry. As you probably know from experience, all is not well: planes are crowded, schedules are wishful thinking, and rates are all over the place. But you probably don't know why. "The industry's primary inefficiencies," write Morrison and Winston, "stem not from its own activities, but from government management of airport and airspace capacity, which limits competition and compromises service."

Bill Gale of Brookings and **Joel Slemrod** of the University of Michigan Business School tackle an issue that is simmering in the background of the presidential campaign: the estate tax. Republicans want to phase it out over a decade. Democrats, meanwhile, smell populist blood: the tax generates little revenue but is arguably the most progressive in the federal code. Gale and Slemrod take the high road. "Although many of the arguments put forth against the current estate- and gift-tax system are specious," they write, "there is also a significant undercurrent of truth. Likewise, supporters of such taxes need to distinguish between the benefits of such taxes in principle and the design problems that arise in practice."

Like Cuba, Vietnam has suffered mightily in the wake of the collapse of the Soviet Union and the end of the cold war. And like Cuba, its socialist elite is not going quietly. But unlike Cuba, Vietnam seems to be poised at the cusp of a great decision. **David Dapice**, a professor at Tufts University and an associate at the Harvard Institute for International Development, writes that "Vietnam has managed to transform itself from a centrally planned economy facing hunger and hyper-

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inflation in the middle 1980s." But, he hastens to add, "it is treading a singular path that few outsiders believe will lead to economic success or social harmony. Much now depends on its will to regain reform momentum."

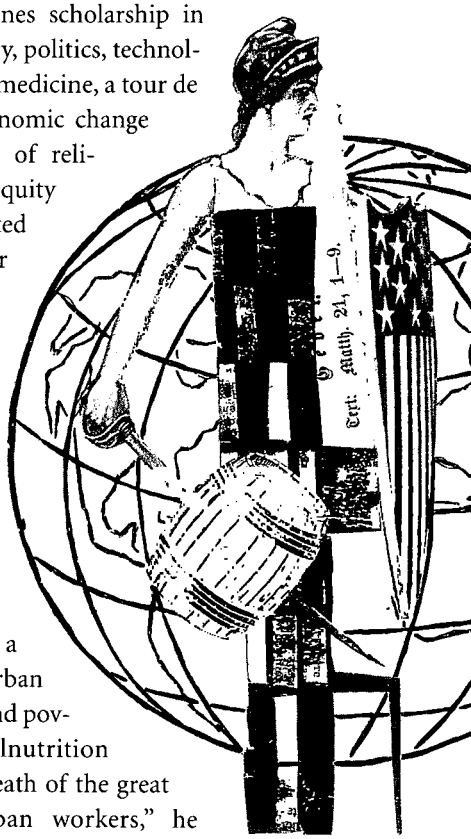
To hear the AFL-CIO tell it, the purpose of trade restrictions is to save Americans from the wages that Chinese and Mexican workers must subsist on. **Greg Rushford**, the publisher of Washington-based *The Rushford Report*, a newsletter on international trade, has been around the block too often to believe that. Often as not, labor loses as much as it wins from keeping out imports. Rushford blames politicians who know better for not telling it like it is. "Bill Clinton has made the calculated political judgement that the American people are not smart enough to understand why open markets are in their interest," he writes. "Although Clinton will leave a free-trade legacy – the North American Free Trade Agreement and China's accession to the World Trade Organization – his administration's unwillingness to explain trade to the public in honest terms has tarnished that legacy."

Speaking of trade, the debate over Nafta on this side of the border focused on jobs – jobs for United States citizens. But such jobs were really a sideshow. At stake was the part the United States would play in transforming the Mexican economy. **Marsha Vande Berg**, editor of *The World Report*, a newsletter on global economics, takes a fresh look at the consequences of Nafta, and her findings should be heartening to those who understand that Mexico is part of the United States' future. "The treaty," she writes, "marked the first time that a developing country established equal footing in a trade relationship with two very powerful, wealthy and developed nations – the United States and Canada. And in the process, Mexico got the opportunity to shed its status as victim."

SIBYLLE SCHWARZ

Now for something completely different: This issue's book excerpt is from *The Fourth Great Awakening* (University of Chicago Press) by the Nobelist economic historian, **Robert Fogel**.

Fogel is best known for his brutal assaults on the academic history establishment. But this work combines scholarship in economics, history, politics, technology, religion and medicine, a tour de force linking economic change to the evolution of religion. "The new equity issues in the United States no longer arise from the shock of rapid urbanization, the destruction of small businesses by competition from industrial giants, the disappearance of the frontier as a safety valve for urban unemployment and poverty, or the malnutrition and premature death of the great majority of urban workers," he writes. "Quite the contrary, the new issues are to a large extent the product of the solutions to these problems."



Rounding out the issue are some regular features: A roundup on the latest economic policy research, a book review by **Paul Portney**, the president of Resources for the Future, the latest from **Glenn Yago** on the economics of peace in the Middle East and, of course, *Ekinomix*, by our cartoonist, **Mark Alan Stamaty**.

— *Peter Passell*

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BY MARCUS NOLAND

On the eve of the normally uneventful spring meetings of the World Bank and International Monetary Fund, Washington D.C. police increased their presence in the neighborhood around the two institutions. Bank and fund employees were instructed to exchange their pinstripes for blue jeans so as not to attract the attention of the gathering protesters.

Still, it was a shock when, on the afternoon of April 14, a truck piloted by two members of the organization People for the Ethical Treatment of Animals dumped a truckload of manure in front of the World Bank headquarters. Television reporters rushed to the scene and soon Police Chief Charles Ramsey himself was there, supervising the cleanup. The games had begun.

Two days earlier across town there had been little press and no police presence in a House hearing room, where the anything-but-attention-getting Prof. Allan Meltzer droned on about the report of the Congressionally appointed International Financial Institutions Advisory Commission that he had chaired. While the street protesters' concerns appeared at times to be only tenuously related to the activities of the two Bretton Woods institutions, Meltzer and the majority of his fellow commissioners were proposing the most radical restructuring of the international financial institutions in half a century. And although Meltzer later denied any affinity with the street protesters, the two groups seemed to manifest a symbiosis of purpose. Indeed, by the end of the protest weekend, left-wing sociologist Walden Bello would be gravely commending the Meltzer report to the demonstrators.

MARCUS NOLAND is a senior fellow at the Institute for International Economics in Washington.

THE NON-BRAWL ON THE MALL

The approach of the spring meetings was greeted with unease by Washingtonians, who feared a reprise of the Battle of Seattle that accompanied the biennial ministerial of the World Trade Organization in late November. Yet the protests in the nation's capital paled by comparison in both size and violence.

For one thing, the World Bank and the IMF made far less inviting targets than the WTO. Unlike the Seattle gathering, which was to launch the "millennium round" of world trade negotiations, it is less clear, even to insiders, what transpires at the spring meetings of these two institutions. (Quick: name one decision undertaken at last year's meeting.)

This difference was starkly delineated by the AFL-CIO's decision not to participate in the Washington protests. The unions had turned out members in massive numbers in Seattle, with AFL-CIO president John Sweeney leading their march. And Big Labor

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KHUE BUI/AP WIDEWORLD PHOTO

was in Washington that week in April to protest the extension of permanent normal trading relations to China. It would have been easy for the union leaders to shift their own China rally back a couple of days and, in effect, combine the two protests against globalization. But in the wake of the vandalism in Seattle, AFL-CIO leaders decided to distance themselves from the broader anti-globalization movement and to save their political capital for the China vote.

Indeed, the AFL-CIO honchos were careful to get their members out of town before the planned protests against the World Bank and IMF institutions that weekend. As a consequence, those protests were smaller and carried less clout.

A second difference was the behavior of the police. In Seattle, the locals appeared unprepared despite abundant intelligence and the precedent of the "Carnival Against Capitalism" in London, during which protesters displayed considerable small-group tactical acumen and inflicted a considerable amount of property damage. By contrast, the Washington D.C. police have extensive experience in dealing with mass protests – there is some kind of protest nearly every spring weekend in the capital – and in this instance, they had the advantage of learning from the experience in Seattle.

The Washington police attempted to infiltrate the protest groups, an endeavor rendered difficult by the decentralized organization of the demonstrators. But police intelligence did enable the seizure of materials used to make "sleeping dragons" – chains linking protesters that cannot be broken up quickly without severing limbs – and they raided the protesters' headquarters on what organizers alleged were trumped-up fire code violations.

On the morning of Saturday, April 15, as Washington geared up for mass protests the next day, I noticed two unmarked police cars

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outside my neighborhood coffee shop, within easy walking distance of the bank and fund headquarters. Once inside the shop, I stood in line behind what I took for anti-globalization protesters. But heading out the door after getting breakfast, I observed one of the "protesters" unlock the door of the police car. And as he retrieved gear from the back seat, I noticed that he had a gun, radio and handcuffs under his parka. The four undercover cops then ambled off down 19th Street.

I walked across the street to Dupont Circle, where a colorful crowd was gathering. I couldn't see any "Save the Sea Turtle" placards, though I did notice some snappy banners. Entering the Circle, I was greeted warmly, but the demonstrators didn't want to talk about the World Bank. This wasn't the Anti-Globalization March; this was a Gay Rights March. As I said, springtime is mass demonstration time in Washington.

REVENGE OF THE NERDS

While the protest organizers plotted the disruption of the World Bank and IMF meetings, the International Financial Advisory Commission issued its report. The commission had its origins in a November 1998 political deal when the specter of the Asian financial crisis spooked the United States Treasury into asking Congress to increase America's lending commitment to the IMF.

The Republicans' quid pro quo was the establishment of a panel of outside experts charged with assessing the international public sector financial institutions. Meltzer, an expert on monetary policy at Carnegie Mellon University who is also known for his torment of the IMF, was chosen to head the commission. Although the majority report contains much that is sensible, it is an uneven and deeply flawed document.

The majority argues, correctly, that the world has changed fundamentally since the establishment of the World Bank and International Monetary Fund during the Bretton Woods conference at the end of World War II. The IMF was set up to help countries experiencing balance-of-payments crises in a world in which exchange rates were fixed and impediments to financial flows were ubiquitous. Today we have floating exchange rates and near-universal currency convertibility. The IMF has become irrelevant to economic policymaking in major industrial countries and is mainly engaged in providing lending and advice to developing countries and so-called "economies in transition."

The World Bank, initially set up to provide reconstruction assistance to the war-ravaged industrial economies of Western Europe, accomplished that goal a generation ago and has taken up promoting economies that were never developed. In short, having outlived their original mandates, the two institutions have turned to new tasks. Some might call this enterprise. Others would label it mission creep on the part of bureaucrats eager to keep their power and perks.

The Meltzer Commission takes this typical critique a step further. It claims that the world economy has experienced an increase in financial volatility. And that this increase in instability is due to "moral hazard" on the part of investors who make risky investments in emerging markets, secure in the knowledge that, should their investments turn bad, they will be bailed out by the IMF. The logic of this argument – that the existence of implicit insurance through the IMF undermines prudence – is unassailable. The issue is what to do about it. And here the report falls short, with radical restructuring of the international financial institutions served up as if the virtue of change were self-evident.

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Perhaps this is too harsh. It is always easier to criticize the status quo than to formulate viable alternatives. The catch, of course, is that the Meltzer Commission will not be remembered for its critique of the current system, but for the reforms it espoused.

The commission's recommendations are quite sweeping. If the majority had its way, the IMF would end both its long-term lending and its below-market-rate lending programs to become a "quasi-lender of last resort" that offers short-term financing to solvent emerging economies at penalty rates. The IMF would not look kindly on requests for support from countries that refused to adopt either rigidly fixed or freely floating exchange rates.

As for the World Bank, it would be abolished and replaced by a World Development Agency that would differ from the existing institution in very important ways. First, middle-income countries and countries with "investment-grade" credit ratings – a list that includes China, Egypt, South Africa and Brazil, to name a few – would be excluded from WDA financing. Second, financing would take the form of grants rather than loans, to be paid directly to service providers without the intermediation of local government authorities.

Similar transformations would be undertaken at existing regional institutions, such as the Asian Development Bank and the Inter-American Development Bank. And, with the exception of Africa, most operations would devolve to these regional banks. The International Finance Corporation, the arm of the World Bank that lends to the private sector, would be abolished, as would similar private lending operations at the regional development banks. The report also targets for extinction the Multilateral Investment Guarantee Agency, a World Bank unit that protects foreign investors against risks such as war and expropriation.

The conduct of the IMF and the World Bank is no longer immune to influence by assorted vivisectionists, Naderites and isolationists.

Anticipating that Meltzer and Co. would issue a strongly "market-oriented" critique of the international financial institutions, the Treasury preempted the commission with its own reform recommendations. In a speech delivered in December, Treasury Secretary Larry Summers called on the IMF to phase out long-term lending and to focus on a narrower crisis-prevention mission. In particular, he endorsed the notion that the fund should play lender of last resort at "prices to encourage rapid repayment."

But in a nod to some Congressional Democrats and in sharp distinction to the Meltzer Commission, Summers seemed to support the sort of intrusive conditionality that proved so controversial in the Asian crisis. "Issues of social cohesion and inclusion. . . should be addressed as a condition for IMF support," he argued.

The Treasury thus seems to want it both ways: short-term financing with conditions still attached. But if the IMF is offering only short-term financing at penalty rates, then there is a reduced need for policy condition-

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ality, much less the intrusive sort in the Asian crisis packages.

While one can thus divine the development of a consensus in the United States (at least among the suits), the rest of the world has shown far less enthusiasm for reform. Developing country governments have been openly hostile – and understandably so. An early draft of the Meltzer Commission report openly advocated the return of development bank capital to its shareholder countries, which would have amounted to a multi-billion-dollar transfer from the poor countries to the rich. (By contrast, the report's final draft cloaks the financing of the WDA grant scheme in obfuscation).

Japanese government reaction has been cool both to the near-obsession with moral hazard from Meltzer and the "less money with more conditions" stance of the Treasury. The European Union has shown the greatest willingness to consider reform of the IMF, if for no other reason than Europe's need to reach an accommodation with the United States if it wants to retain its hold on the managing directorship of the fund.

Horst Kohler, the recently appointed managing director, has made a show of listening to critics in the United State and elsewhere – notably Asia, where considerable bitterness lingers over the fund's activities in 1997-98. The Asian Development Bank has gotten the message and is now emphasizing "poverty alleviation" over the bricks-and-mortar infrastructure lending that has been its forte. The World Bank and its combative president, James Wolfensohn, appear to be exceptions in this regard, opposing rather than accommodating the Meltzer Commission criticisms. Perhaps this is not surprising: While the Meltzer-Treasury consensus would shake up the IMF, acceptance of the Meltzer Commission recommendations would end the World Bank as we know it.

CONFRONTATION

Back on the street, the atmosphere was giddy with anticipation as the sun rose over Washington on the third Sunday in April. Small groups of protesters began making their way toward the World Bank and IMF buildings. As they approached, however, they found that the police had established a security perimeter around the site, sealing off numerous city blocks. The protesters responded by forming their own lines, so that lines of riot police and protesters confronted each other across police barricades. In only a few instances were protesters able to form "sleeping dragons" to block intersections; in most cases, their lines consisted only of demonstrators linking arms. By 6:30 a.m., the conference organizers had successfully bused most of the bank and fund delegates into the meeting, and the protesters were left with little to do except mill around and attempt to block the exit of the delegates in the afternoon.

The crowds were small – even protest organizers would claim only 10,000 participants – and overwhelmingly white and student. Oddly, despite the IMF's well-deserved reputation for the imposition of macroeconomic austerity on poor countries, it was the avowedly do-gooder World Bank that was the focus of the protesters' ire. According to one demonstrator, the bank "wrecks the environment and impoverishes Mozambican cashew nut farmers – didn't you know?" Whereas the fund . . . well, it is unclear to almost everybody but insiders what the fund does. Improverishing peasants trumps the sin of tight money every time.

In the days leading up to the protests, the organizers had encouraged consensus around

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Spring Break for the politically correct?

JOHN HARRINGTON/BLACK STAR

a few principles, including non-violence, in the context of an avowedly decentralized and non-hierarchical movement. A majority seemed to subscribe to these principles, though a distinct minority argued that the destruction of private property in rich countries was small change compared with the depredations of the Bretton Woods institutions in developing countries. Besides, if they were paying their own freight, they could, and would, behave as they pleased.

The anarchist bands, as distinct from the dominant neo-hippy majority, looked ready for war, with facial coverings to conceal identification, gas masks and goggles for operation in tear-gassed environments and, in the case of one band, shields fabricated out of garbage can lids. However, during the long hours between the dawn confrontation and the expected confrontation when the delegates would attempt to leave, the protesters spent their time beating drums, throwing Frisbees and parading around the security perimeter.

In essence, this was spring break for the politically correct, a big adventure where you got to stop traffic, confront cops and meet members of the opposite sex – attractions that should not be entirely dismissed. Indeed, as one who participates in the annual Fourth of July pedestrian seizure of Connecticut Avenue can attest, challenging authority can be fun. But I like to think that, as a callow youth, I was a little more sophisticated about politics and economics.

The frolicking aside, the protesters did meet their match in the D.C. metropolitan police that weekend. Waiting for the afternoon confrontation, I asked two young protesters what they would do if the police brought in horses to control the crowd. They hadn't thought of that. Later, one of the protesters, perhaps confusing himself with the Alex Karras character in *Blazing Saddles*, punched a horse.

WITHOUT A BANG

The following day was a rainy school day, and the protestors dwindled into the hundreds. It would be wrong, though, to regard the anti-globalism protests as sound and fury signifying nothing.

Criticism from both the street protesters and their bespoked counterparts is unlikely to diminish. And frustration with the lack of change could encourage the Asians to go their own way, establishing new regional institutions as complements or substitutes. At the very least, the two aging Bretton Woods institutions are now "in play." For better or for worse, their conduct is no longer immune to influence from assorted vivisectionists, Naderites and isolationists. M

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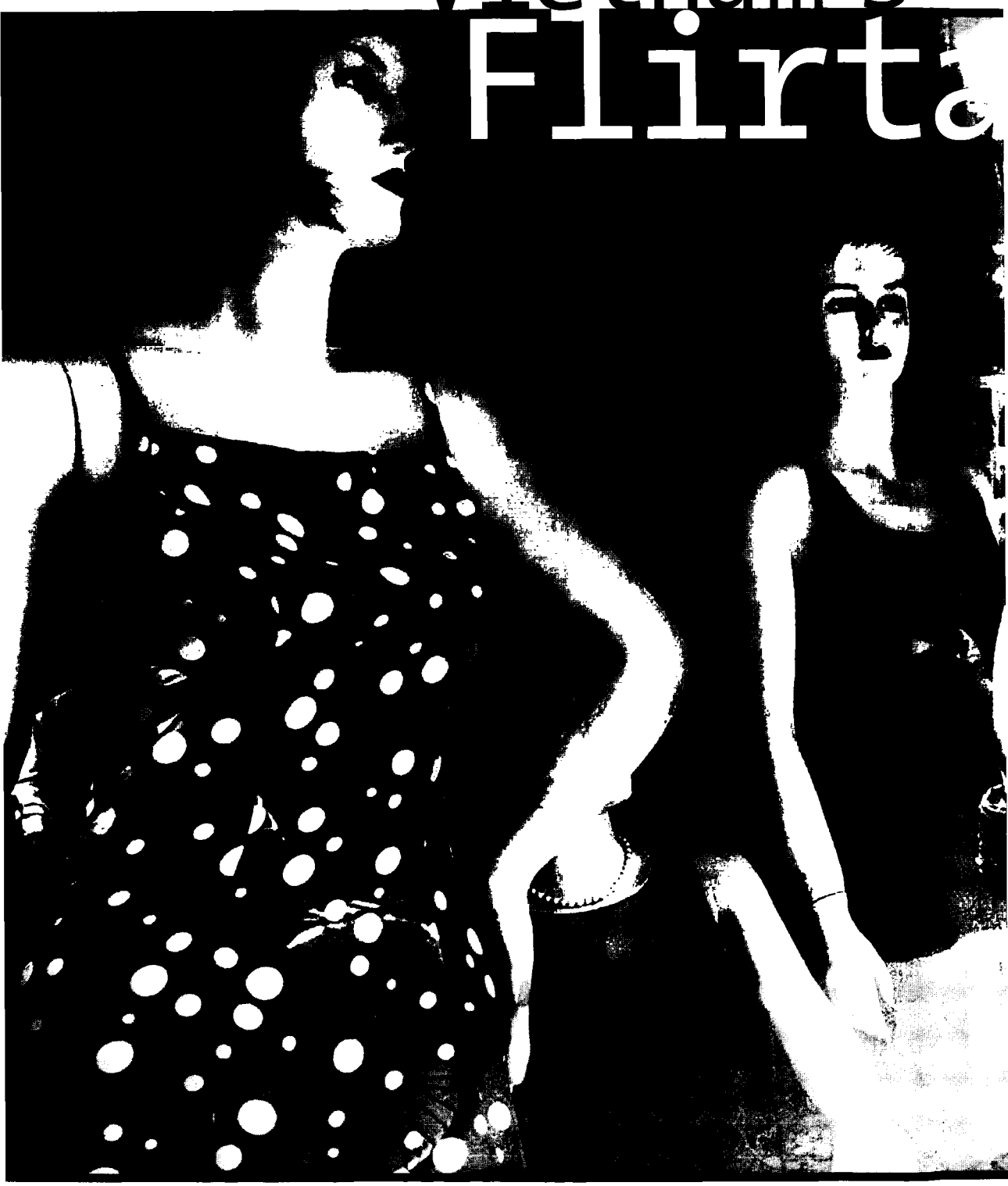
Vietnam's Flirta



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tion development

By David Dapice

Vietnam is a country of 80 million literate and hard-working people, in the middle of the fastest-growing region of the world. It has nearly the land area of Germany, a solid agricultural base, reasonable reserves of oil and gas – and one of the lowest living standards in the world. Measured in terms of purchasing power, Vietnam's per capita income is just 6 percent of that of the United States.

Yet during the 1990s, Vietnam was also one of the fastest-growing countries in the world. Plausible estimates suggest that poverty may well have fallen in half from 1988 to 1998 while incomes doubled, and the improvement of its rural sector since 1990 is little short of revolutionary. Exports tripled from 1993 to 1998, and grew by a quarter in the first six months of this year over last.

In spite of this recent success, though, Vietnam's prospects are deeply clouded. Many observers are predicting sluggish growth, due to falling foreign investment, slow utilization of aid, a weak private sector and an inefficient state sector. In short, Vietnam has managed to trans-

DAVID GUTTENFELDER/AP/WIDEWORLD PHOTO

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form itself from a centrally planned economy that was facing hunger and hyperinflation in the middle 1980s, but has stopped well short of the changes needed to ensure its entry into the club of developed economies. It is treading a singular path that few outsiders believe will lead to economic success or social harmony. Much now depends on its will to regain reform momentum.

HOW THEY GOT THERE

To understand Vietnam today, go back to the end of North Vietnam's war with the Americans. When North Vietnam and South Vietnam were united at the end of that war, the divergent historical experiences of the two nations guaranteed a rocky start. The people in the south, even those who welcomed the fall of the South Vietnamese government, were accustomed to a market economy. There had been effective land reform in the early 1970s in the Mekong Delta, creating a landed peasantry in the rice bowl of the country. So when the government tried to apply central planning to agriculture, there was passive resistance and production stagnated.

This went on for several years. And with the war with the Khmer Rouge raging in Cambodia and the Khmer Rouge's ally, China, threatening Vietnam in the north, the government was in no position to crack down. But the rural reforms were undercut after the immediate crisis subsided. This led to food shortages (in spite of aid from the Soviet Union) and then, with rapid money creation, to hyperinflation in the mid-1980s.

That object lesson was not lost on Hanoi. In addition, its close links with the Soviet Union let the Vietnamese see the implications of Mikhail Gorbachev's *glasnost* and *perestroika*. The Soviet Union, Vietnam's main patron and trade partner, was changing, and they, too, had to change or face the consequences.

REFORMS, A.K.A. *DOI MOI*

The denouement was a debate within the leadership that led to *doi moi*, the homegrown reform program that aimed to maintain a socialist (read single-party) political system while moving towards an economy that used market forces to a greater degree to determine prices and output. The resulting changes were sweeping. Farm families got their own land and were more or less free to plant what they wanted. They could also sell to whomever they wanted – though the government continued to monopolize export markets, so prices were still effectively controlled.

The government gradually got a grip on the printing presses at the mint, and inflation subsided. Interest rates rose above the inflation rate, though the banking system remained dominated by state-owned banks that lent mainly to troubled state enterprises. Foreign-investment laws were liberalized and, after 1990, a huge amount of investment commitments were made – a volume of commitments exceeding the annual GDP.

Yet, government promises didn't quite match the reality. Investors found it difficult to operate businesses and relatively little – a third or less – of the licensed investment was actually converted to capital on the ground.

The period after the fall of the Soviet Union was an exciting and interesting one. Though there was an initial lurch towards the political reaction, the rapid progress in the economy created a climate in which new ideas could be considered. And there was significant movement toward reform – though, paradoxically, this impulse slowed after 1994,

DAVID DAPICE teaches at Tufts University and is an associate at the Harvard Institute for International Development.

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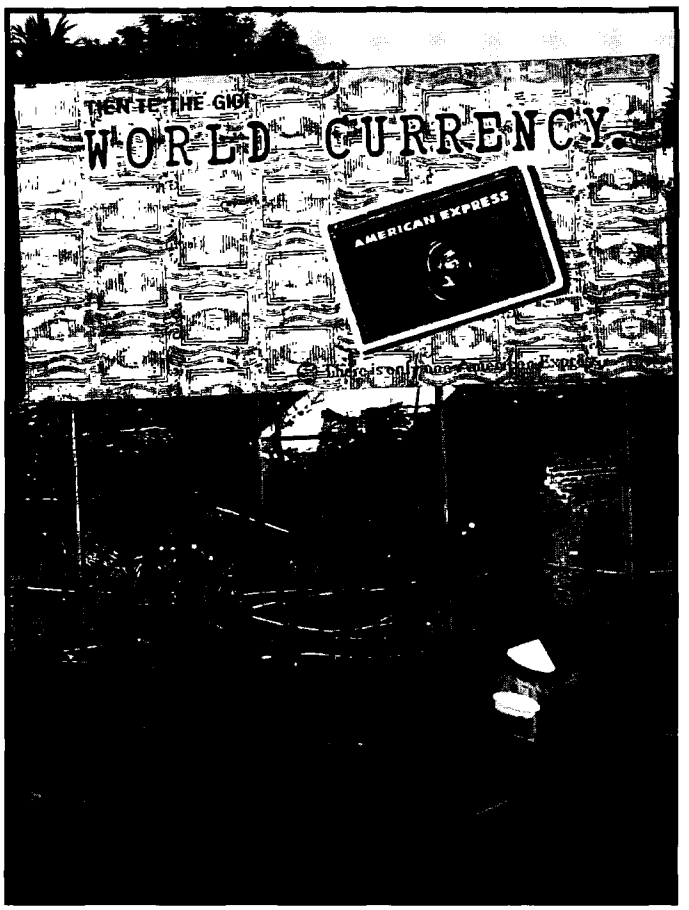
when the United States lifted its veto against loans from multilateral donors and more Western aid flowed into the country.

Along with the modest export revenues realized from growing oil production, these funds allowed the government to avoid tough decisions while still maintaining an 8 to 9 percent rate of economic growth. A 1998 World Bank study shows policy reform slowing and then virtually stopping as aid rose in the early- and middle-1990s. So long as old habits could be followed with such success, it did not seem very urgent to change them.



RADHIKA CHALASANI/NETWORK ASPEN

THE RISING TIDE

The years from 1990 to 1998 were a period of continuous growth in all sectors. Numbers can be wearying, but the gains were too spectacular to gloss over.

Rice production rose 52 percent, to 29 million tons in 1998. Coffee output rose 537 percent, to 409,00 tons, in the same period, making Vietnam the world's largest exporter of the *robusta* varietal used in instant coffee. Sugar cane production rose 152 percent – though only by the inefficient device of pegging the domestic sugar price at twice the world free market price. Rubber, tea, seafood and livestock all showed impressive growth.

Rural deregulation has created a dynamic farm sector that is still growing. Because most people live in rural areas, a 4 percent annual gain in farm output translated into broad-based gains in income. Yet many of the gains from deregulation have already been realized. With 80 million Vietnamese crowded into the rural economy, there is less than an acre of land per farmer. Agriculture is thus a good base, but it cannot make the country rich.

Happily, industry recorded even more impressive growth. Electricity production grew 12 percent a year, nearly tripling in the decade. Cement output quadrupled. Light manufactured exports grew nearly tenfold, to about $4 billion in 1999.

The story in industry is a complicated one, though. Export-oriented industry, much of it based on foreign investment, was fast-growing and efficient. However, it generally was built around using Vietnamese labor to process semi-finished imports, and thus value-added was usually only 15 percent to 20 percent of the export value. Out of industrial GDP output of nearly $10 billion in 1999, perhaps 8 percent of value-added was from

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manufactured exports. Little of the industrial foreign direct investment went into this export sector – certainly less than a quarter.

Foreign direct investment also funded many joint ventures, mainly with state enterprises that sought to replace imports. Their goods tended to to be heavily protected against foreign competition. As in many other nations that have followed this path, the import substitutes were priced high and could not easily be exported into global markets. The output of the joint ventures also quickly exceeded domestic demand, since they were forced to price high to cover costs. This led to attempts to fill the demand gap with public spending, but such policies were merely stopgaps. Indeed, it led to grotesque waste, such as the construction of a dozen car factories that in total produced 5,000 vehicles a year – less than 1 percent of their capacity.

About three-quarters of industrial foreign direct investment fell into this wasteful category. However, there is hope that some of these joint ventures will be able to lower costs and become competitive. This will be necessary if Vietnam is to meet its commitments to lower trade barriers in joining the ASEAN Free Trade area in the next few years.

The ownership structure of the new industry evolved curiously. In 1990, more than 60 percent of all industrial output came from state enterprises; by 1999, this figure had fallen to 44 percent. The foreign sector, including joint ventures, grew very quickly and rose from almost nothing to 32 percent of all industry within the decade. The balance, coming from domestic private industrial enterprises, declined from a third to just over a fifth of output.

Think for a moment what this means. During a decade of rapid growth following liberalization, the domestic private industrial sector lost ground, as did the state sector! The de facto strategy was to rely on foreign investment, nominally in joint ventures, for most of the industrial growth.

With the recent fall-off in foreign investment, this trend has been reversed. In the first quarter of 2000, private domestic industry grew the fastest and foreign industry the slowest. However, this may be partly due to unusual factors like falling oil output (a foreign-sector activity) and better coverage of existing private producers in the data.

The Alice-in-Wonderland quality of the current policy is exemplified by one official who said, "The private sector should have a level playing field so long as the state sector plays a leading role." Of course, the foreign sector has been leading, though it is faltering, and the private domestic sector is remarkably small and weak. If state enterprises must lead, it will be a slow advance, indeed.

The service sector is perhaps the hardest to

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reform. The state telephone monopoly, for example, make rates in Vietnam among the highest in the world. The price of international calling is particularly startling: a call to the United States costs more than $3 a minute, many times more than transpacific calls from other countries in the region. Though not a monopoly, Internet connections are expensive and slow to the point of being useless. Electricity blackouts are not uncommon, and, in spite of an agreement with the World Bank five years ago, there has been almost no progress in allowing private operators to build generating capacity.

State banks, which dominate the banking sector, do not do a good job of providing financial services to private firms. At the end of 1998, private industrial and rural credits equalled $2.5 billion, less than 10 percent of GDP, compared to 40 percent of GDP in Indonesia. Various restrictions hobble the foreign banks that do have offices, and few are profitable. There is no domestic corporate bond market to speak of, although a limited form of stock market may finally appear this summer after years of delay.

State enterprises still dominate international trade, though larger private firms can now trade directly for their own imports and exports. Overall, regulation, monopoly and special interest protection leave Vietnam well behind many of its neighbors. Even when the official policy is fair, implementation is flawed. Vietnam ranks fourth from the bottom of Asian countries with respect to corruption, and dead last on transparency. This raises costs for both domestic and foreign-managed firms.

One might have expected the growth of the 1990s to have been concentrated on a few favored localities. After all, the areas in and around Hanoi get 30 percent of all foreign direct investment, while Ho Chi Minh City and three nearby provinces get nearly half of the foreign investment. Most manufactured exports and industry come from the South, and these have grown the fastest. Yet, as the table shows, the gains of the last decade were still spread fairly widely.

INCIDENCE OF POVERTY BY REGION IN VIETNAM, 1993 AND 1998

REGION	POPULATION (MILLIONS)	POVERTY 1993 (PERCENT)	POVERTY 1998 (PERCENT)	PER CAPITA INCOME 1998 ($)	REAL PER CAPITA INCOME GROWTH 1993-1998 (PERCENT)
Northern Upland	13.5	79	59	1,921	31
Red River Delta	14.9	63	29	2,710	55
North Central	10.5	75	48	2,030	46
Central Coast	8.1	50	35	2,440	29
Central Highlands	2.8	70	52	1,790	25
Southeast (HCM City)	9.7	33	8	4,663	78
Mekong Delta	16.3	47	37	2,350	18

Income calculated at an exchange rate of VD13,000 =$1.

SOURCE: Vietnam: Attacking Poverty, Joint Report of the Government-Donor-NGO Working Group, 1999.

The middle-income regions (the Mekong Delta and the Central Coast) had the least decline in poverty; these regions still had more than a third of their population living in poverty in 1998. The poorest regions generally saw larger declines in poverty, but still must cope with half their people in poverty. The Red River Delta, the area around Hanoi, had the largest decline in poverty, while Ho Chi Minh City (once, Saigon) enjoyed income gains that reduced poverty to just 8 percent.

This reflects the economic activity in that

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market-oriented city, as well as the considerable remittances from relatives overseas. Estimates of those gifts range from $1 billion to $2.5 billion a year – $100 to $250 for each person in the region.

Vietnam did well by other socioeconomic measures, too. Reductions in restrictions on movements of labor, the great jump in food availability and the taming of inflation all helped improve conditions. Primary education is now almost universal, while the percentage of children going to secondary school doubled between 1993 and 1998, to 60 percent. Most Vietnamese put a high value on education, and higher private incomes have helped ensure that more children are able to stay in school and to afford the costs of books, uniforms and tutoring.

The rate of mortality by age five, which had been more than 10 percent in the 1980s, had fallen to 4 percent by 1997. Thus, while Vietnam remains poor by virtually any yardstick, the last decade has been one of striking and widely based economic and social progress.

BUBBLES, CRISES AND BOTCHED TRADE DEALS

The flood of capital that washed into China, Thailand, Indonesia and Malaysia from 1993 to 1997 also lapped ashore in Vietnam. Many investors came with more enthusiasm than sophistication about making capital productive in pre-capitalist economies. And as the initial jolt from their funds lifted the growth rate, the belief of Vietnam's ruling conservatives that not much institutional change would be necessary was reinforced. It appeared that Vietnam could insist on cumbersome joint ventures, impose high costs of services and restrict hiring. Vietnam had been important during its wars, so why shouldn't it be attractive in peace?

The government was even able to avoid releasing reliable economic data, without any severe impact on investor interest. In spite of billions in aid from the World Bank and the International Monetary Fund, Vietnam stands almost alone in the world in not having a page of economic data in the IMF's monthly publication.

The crisis in Asia affected Vietnam's attitude toward foreign investment as much as it affected foreign investors' attitudes toward Vietnam. Just as some older United States stock market investors treat every downturn in the Nasdaq as the final, inevitable bursting of an irrational bubble, so some socialists believed that the prosperity of much of Asia was unstable. They distrusted the market and the volatility it brought.

Since their richer capitalist neighbors collapsed and China did not, they decided that it was safer to keep some distance from the global economy. This meant not only maintaining an unconvertible currency, but also hanging on to state enterprises and the tightly regulated banks that funneled resources into them. By the same token, public monopolies would not be abandoned. Their view is not confined to socialists alone: Dr. Mahatir Mohamad, Malaysia's capitalist-baiting strongman, is a very popular figure in some Vietnamese circles.

This worldview led to one of the most bizarre decisions by any Asian economy in recent years: the rejection of a bilateral trade agreement with the United States. After straining for years to hammer out a bilateral trade deal, the governments announced success in the summer of 1999. Both sides had made compromises. All in all, the bilateral trade agreement was very similar to the one the Chinese signed later in 1999, but had longer adjustment periods. Vietnam was give

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seven years to open banking and telephone services to foreign competition. The deal would have lowered United States tariffs on Vietnamese manufactured goods; Vietnamese exporters are now stuck paying prohibitive rates left over from the Depression era. One estimate suggested the pact would generate an $800 million gain in exports to the United States in the first year, with much larger gains over time as the export economy expanded.

Although Vietnam's manufactured exports have grown very rapidly, they expanded from a very low base. In 1999, they had reached a level of $4 billion. In contrast, the manufactured exports of the sluggish Philippine economy grew by $4 billion *annually* in recent years. There is no doubt that further export growth would have provided badly needed jobs, foreign exchange and technology.

However, in the wake of the Asian crisis, conservatives in Vietnam were able to retract approval of the trade deal. Many in the state enterprises worried about their viability if they had to compete with lower tariffs and fewer friendly banks. There were ideological and security concerns, too, especially about losing control of communications. All this was fed by a general distrust of Americans in response to lingering anti-Vietnamese feelings in the United States.

Besides strong anti-Communist feelings among many Viet-Kieu (overseas Vietnamese), there is Radio Free Asia, a United States government funded propaganda station that broadcasts in Vietnamese and takes a generally anti-government line. It is normally jammed and is resented as unfriendly. What's more, periodic statements by American politicians feed the perception of hostility. Even Senator John McCain, who has probably done more for Vietnam and for United States-Vietnamese relations than almost anyone in the Congress, was recently in Vietnam and quoted as saying, "The wrong side won." Perhaps, then, it should not be surprising that only in the last month has a political coalition favoring closer ties to America been able to push through the free-trade pact.

Growth in 1998 and 1999 fell to about half the level of the 1990-97 period. Foreign investment is quite low now, in spite of various regulatory adjustments that have made it easier to invest. The lack of access to United States markets, a glutted domestic market, poor profits, corruption and lack of government transparency have given Vietnam a bad reputation. Many firms are leaving or scaling

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down their activities. Some export-oriented investments are still coming into the South, but Nike is reconsidering its commitment to producing shoes in Vietnam. Nike's departure would knock out 50,000 badly needed jobs, and cast an even deeper pall over foreign investment.

Exports of manufactures are still growing,

but it's far from clear that the growth is sustainable. The current strategy is to rely on preferences for garment exports to the European Union. It will probably take some experience with a real slowdown before the message sinks in that the decision to turn down a bilateral trade deal with the United States was at best, a setback.

Assuming the just-announced trade deal goes through, Vietnam will have a shot at catching up to its neighbors, which drew the opposite conclusions from the Asian financial crisis and are allowing, even encouraging, more foreign investment, and moving toward greater transparency and global integration. But in a world moving at electronic speed, the decision-making process in Vietnam remains deliberate.

It is hard to accept that the world has changed and one's own position in it has diminished. Yet that is the case for Vietnam. What was a focal point in the Cold War could become a backwater. Its economic size is tiny, with both GDP and exports behind that of New Zealand. Good, cheap labor is useful, but can be found elsewhere.

Yet the government continues to pour money into politically useful but economically questionable state-owned ports, refineries and bridges while few loans go to private industry. The world has moved on, and even traditional donors such as the Japanese seem to be losing patience with the stalled reforms. Certainly, few foreign investors still have Vietnam on their radarscopes. Actual gross foreign investment in 1999 was about $600 million, compared to 1996 commitments of $8.6 billion and cumulative approvals of more than $30 billion.

If the foreign sector is losing interest, the state sector is moving slowly. Its accumulated debts of $14 billion in 1999 amounted to half of GDP. Few of the 5,300 state-owned enterprises want to privatize, or move toward a joint-stockholding structure, in spite of a policy directive to do so. About 7 percent have made the jump, but most of these are small and many were losing money when they were forced to change their status.

Results of these forced changes have been mixed. The state sector, including all levels of government, as well as the state enterprises, is adding fewer than 80,000 workers a year. Yet the labor force is growing by 1.2 million annually. If Hanoi tries to put the burden of industrialization on the state enterprises, there will be few jobs and little industry because structural inefficiencies limit their profit potential. The government budget would scarcely be able to support the added demand for cash. With Vietnam's credit rating at a dreary B1 level, access to nonconcessionary loans will be limited.

This leaves the burden of development on the domestic private sector. While small busi-

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ness is allowed, growth beyond a few dozen employees often brings unwanted attention from the authorities. Many larger private employers still do not use banks. Some avoid building a central factory, so that they can spread out their activities and keep a low profile. While recent rhetoric has emphasized the need for the private sector and some bureaucrats have taken it to heart, it will take some time to see if this is another zig before another zag, or a real change in direction.

Passage of the Enterprise Law in January 2000 secured rights to run private businesses, and thousands of new firms have sprung up. Private domestic output is up a startling 17 percent in the first five months of this year, though some of this growth may come from firms that already existed but decided it was a good time to register. Note, in any case, that growth starts from a low base. There were only 465 private industrial firms with more than 100 workers, according to a 1998 survey. Vietnam's 5,620 registered private manufacturing firms employed 264,000 workers, just 7 percent of all industrial employment.

PROSPECTS

As Yogi Berra once said, it is hard to predict, especially about the future. Poor nations have a capacity to grow faster than rich ones because they can build on the shoulders of foreign technology and foreign demand. Besides, Vietnam has the capacity to surprise – and also to do better than it should.

It is likely that some southern provinces will manage to keep growing because they have adopted a business-friendly stance and because there are still a lot of export opportunities left for Vietnam in Asia and Europe. Yet in a country of 80 million with dysfunctional banks, limited foreign investment, poorly used aid and no other meaningful capital markets, it is hard to see how Vietnam will compete with China or neighboring ASEAN countries. China, with permanent normal trade status and World Trade Organization membership, will attract more efficiency-inducing foreign investment. Meanwhile, the ASEAN market economies are reforming and will have low tariff entry into Vietnam by 2005. Vietnam's borders are porous in any case: electronics, motorcycles and even foreign sugar (which is far cheaper than the protected domestic crop) are smuggled into the country.

The rural sector can keep growing, but not as fast as in the past decade. Rapid growth in the service sector will rely on deregulation, and that is coming very slowly. The industrial sector will need a change in policy to avoid a dead-end reliance on high-cost industries. Public investments tend to follow a political rather than economic logic, and the accumulating debts will not be easy to service in the medium run.

That said, growth this year will probably be about 6 percent, largely due to higher crude oil prices and rapidly expanding public spending. There is no crisis looming, just a prospect of slowing growth over time.

The best thing going for the Vietnamese is their pragmatism. If they can gain the vision to see their own self-interest, they will succeed. Vietnam's hidden tangible asset is the relatively small size of the state sector and of the banking system, which will make the cost of transition to markets modest in comparison to China. Laying off just 1 percent of the work force and spending 2 to 4 percent of GDP for bank bailouts would be enough to start afresh.

Just as in the past, the Vietnamese will make their own decisions, on their own schedule. One can only hope they manage to increase the tempo, for the world is no longer waiting.

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A $20 Billion Misunderstanding

The Government's View of Airline Deregulation

By Steven A. Morrison and Clifford Winston

RON CHAPPLE/FPG INTERNATIONAL; INSET: KEN REID/FPG INTERNATIONAL

Fed up with crowded planes, delayed flights and that mysterious slab of carbohydrate and cheese derivative the airlines call lasagna? Furious that you paid $951 to fly to Tulsa, while the slob in the row ahead – the one with his seatback in your lap – was able to buy an identical seat for $232?

You, and 10 million other folks. Washington has responded with some fierce bombast. Among the would-be targets: high fares for flights from dominant airport hubs and from small cities, biased flight information generated by computer reservation systems and travel agents paid to funnel business to specific carriers, competitive advantages conferred by

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frequent flier programs, and collusion among carriers. Recently the list has lengthened to include efforts by large carriers to put smaller ones out of business, as well as the airlines' shabby treatment of customers.

The US Department of Transportation issued – and then withdrew after considerable debate – guidelines to identify predatory behavior and establish acceptable parameters for fare cuts by major carriers. Senators Herb Kohl and Patrick Leahy have urged the department to investigate "unfairness" in airline pricing. The Justice Department has filed an antitrust suit against American Airlines for predatory behavior and may bring suits against other carriers. Congressional proposals have ranged from creating a commission to review airline-pricing strategies to establishing a "passenger's bill of rights."

All this activity is said to recapture the spirit of deregulation. But policymakers have yet to provide systematic evidence either that travelers' welfare has been compromised by anticompetitive practices or that government intervention could improve matters. In fact, a close look suggests the opposite.

Since the airline industry was deregulated in 1978, average fares have been consistently lower than they would have been had they still been regulated.* What's more, the savings have been widely shared. In 1998, 80 percent of passengers, accounting for 85 percent of passenger miles flown, paid lower fares than they would have under regulation. We estimate that annual benefits to travelers from airline deregulation in the form of lower fares and increased flight frequency – now exceed $20 billion.

Ironically, the industry's primary inefficiencies stem not from its own activities, but from government management of airport and airspace capacity, which limits competition and compromises service.

Ironically, the industry's primary inefficiencies stem not from its own activities, but from government management of airport and airspace capacity, which limits competition and compromises service. Policymakers' initiatives seem more related to lobbying by special interests than to encouraging competition to improve the general welfare of travelers.

ARE TRAVELERS TREATED UNFAIRLY?

Congress pays particular attention to the airline industry because its members fly frequently and, like their constituents, feel heads should roll when they have a bad experience. Notwithstanding delays and lost luggage, the complaint heard most often on Capitol Hill is that travelers flying to or from small communities or hub airports dominated by a single carrier are treated unfairly because they pay higher fares than others pay on routes of comparable distances.

Travelers from small cities do, indeed, pay higher fares than travelers from larger cities. There are two possible explanations.

STEVE MORRISON teaches at Northeastern University.
CLIFF WINSTON is a senior fellow at the Brookings Institution.

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One is a lack of competition. Although large cities are generally served by more airlines than small ones, this does not affect fares as much as is widely assumed. According to our research, differences in competition account for just 10 percent of the measured difference in fares.

The more passengers on a route, then, the greater the cost savings. Naturally, the larger the cities that make up the route, the greater the traffic – and the larger the planes serving it and the more fully loaded they are. By our estimates, differences in load factors account for about half of the differences in fares for small routes relative to large ones. And differences in aircraft size account for about 40 percent of the difference.

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The other explanation for the fare difference is airline costs. Cost differences arise from differences in aircraft size and "load factors" – the share of seats filled by paying passengers. Not surprisingly, the cost per seat is lower on large planes than on smaller ones because the fixed costs of aircraft operations are averaged over more seats. And, of course, costs per passenger fall as more seats are filled for planes of any size. Although carriers could fly big planes on routes with few passengers, they would have to cut flight frequency to fill enough seats to cover costs and earn a profit. And because travelers value frequent service so much, carriers on less busy routes find that it pays to provide, say, small-plane service three times a day, rather than a large plane once a day.

Hence, fully 90 percent of the difference in fares is attributable to underlying cost differences, rather than the effects of limited competition. While the higher fares may be frustrating to travelers to and from small cities, they are not unfair.

A second frequent complaint about air travel involves the "hub premium" – the elevation in fares that travelers pay on routes to and from an airline's hub city (Delta in Atlanta, Northwest in Detroit and Minneapolis, etc), as compared with the fares on comparable routes not connected to hubs. The idea of a hub premium fits nicely into conventional economic theory. A carrier with

*This and other assertions in the article are documented in our technical papers. See "The Remaining Role of Government Policy in the Deregulated Airline Industry," in Sam Peltzman and Clifford Winston, editors, Deregulation of Network Industries: What's Next? (Brookings, 2000), "The Fare Skies: Air Transportation and Middle America," Brookings Review, Fall 1997, and our book, The Evolution of the Airline Industry (Brookings, 1995).

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a large share of departures at an airport generally can offer more convenient service than competitors. Thus, a dominant carrier ought to be able to raise its fares without losing much traffic.

But measuring hub premiums is difficult because it is not clear what other factors should be held constant to ensure a fair comparison between fares on hub routes and fares on other routes. In earlier research, we showed that accounting for such variables as route distance, number of plane changes, the mix of business and pleasure traffic, carrier identity and frequent flier tickets makes the comparison more appropriate. It also lowers the hub premium.

More recently, we found wide variation in the hub premium depending on whether Southwest Airlines, the low-fare juggernaut that does not generally challenge the big carriers in their hubs, is included in the comparison group. When policymakers claim that travelers on dominant hub routes pay excessive fares, they are really saying that all travelers pay excessive fares when Southwest does not serve the market.

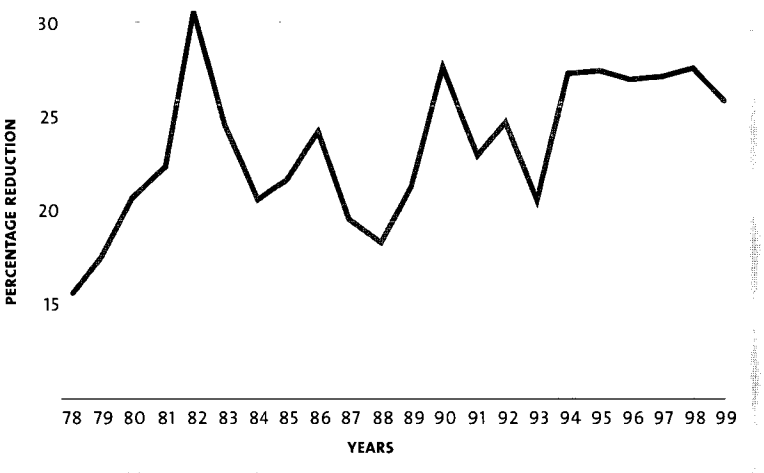
At any rate, the hub premium appears likely to decline because other low-fare carriers have been putting in an appearance at dominant hubs. For example, Frontier recently expanded operations at Denver's airport, a United hub. Note, too, that in spite of the fact locals love to complain about hub airlines, city officials encourage hub development because greater flight frequency stimulates commerce and benefits travelers.

Yet another familiar criticism is that variations in fares have been larger since deregulation. However, as in the case of small communities, these variations often reflect differences in costs.

Business travelers, for example, place a much higher value than pleasure travelers do on being able to book a seat at the last minute. Airlines therefore reserve more seats for business travelers relative to their expected demand than they do for pleasure travelers – a service for which business travelers pay extra. Some price variation is also due to the proliferation of "niche carriers" like ProAir and Vanguard, which price low and thereby stimulate a greater range of fare offerings by all carriers.

To be sure, some fare differences also reflect carriers' ability to charge fares based on passengers' willingness to pay – classic price

AVERAGE SAVINGS IN FARES, RELATIVE TO REGULATED FARES



SOURCE: Steven A. Morrison and Clifford Winston, "The Remaining Role of Government Policy in the Deregulated Airline Industry," in Sam Peltzman and Clifford Winston, eds., *Deregulation of Network Industries: What's Next?* (the Brookings Institution, 2000).

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discrimination. And though such discrimination is often perceived as unfair, it fills seats that would otherwise be wasted and opens air travel to millions of middle- and lower-income Americans.

WHAT ABOUT SERVICE?

Policymakers cite the increase in customer complaints received by the Transportation Department during the 1990s as evidence that airline service is at an all-time low. But if one controls for the growth in air travel, a different picture emerges.

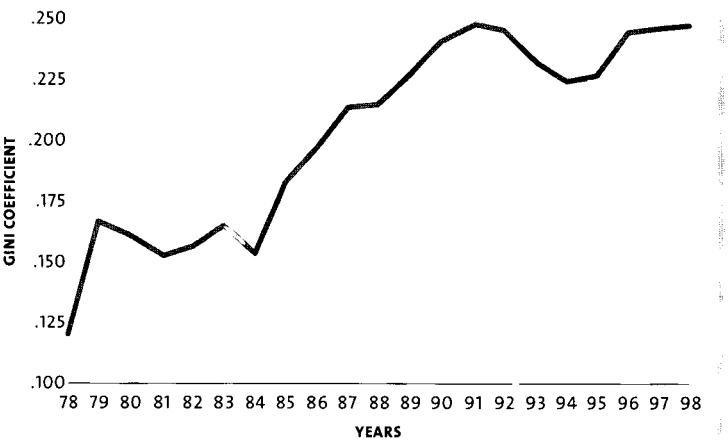
Complaints per passenger-mile increased immediately after deregulation and then decreased until the industry completed its merger wave in the mid-1980s. After peaking in 1987, passenger-mile-adjusted complaints declined sharply until 1990 and have remained fairly constant since then. The increase in complaints in 1999 – they nearly doubled despite industry improvements in on-time performance, baggage handling and overbooking – is apparently attributable to the proliferation of Web sites that have made it much easier for travelers to complain to the Transportation Department.

What has changed in the last decade is that planes have become more crowded: today, an average of 71 percent of seats are filled compared with 62 percent in 1990. And a statistical analysis of the factors underlying complaints bears out the common-sense inference that passengers on crowded planes are more prone to carp – each percentage point increase in average load factor leads to an additional 6.4 complaints per billion passenger miles.

Indeed, holding the crowding variable constant, there has been a significant decline in complaints per passenger-mile flown. Thus, the current dissatisfaction with air service appears to be largely attributable to pressures on carrier capacity – a problem that does not call for government intervention.

What about specific complaints like over-booking and delays? In 1998, only 1.1 million out of 514 million passengers – one passenger in 500 – were denied boarding because of overbooking. That figure includes just 45,000 passengers who were bumped involuntarily (and compensated). Delays have increased recently, but the Federal Aviation Administration accepts much of the blame. The FAA admits that it uses airspace inefficiently and responds slowly and clumsily to bad weather.

FARE DISPERSION IN U.S. DOMESTIC MARKETS



Dispersion is measured by the Gini coefficient. Multiplying the Gini coefficient by two gives the expected difference in fares for two randomly chosen tickets as a percentage of the average fare.

ARE CARRIERS COMPETING UNFAIRLY?

Government agencies should, of course, be on

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the lookout for unfair or illegal practices by carriers. To date, however, public authorities have focused on behavior that has little effect on traveler welfare.

Imperfect Information. As fares and schedules proliferated under deregulation, carriers developed their own computerized reservation systems. In the 1980s these systems were criticized as being biased, preventing travelers and travel agents from getting the lowest available fares or most convenient flights. Before it went out of business in 1984, the Civil Aeronautics Board made it illegal for the owner of a computerized reservation system to list its own flights more prominently than those of other carriers. Congress subsequently required that travel agents be able to use the systems to book flights for all participating airlines with equal ease.

But these actions have had little real impact because most fliers want more than a cursory search of a computerized reservation system. Many, hooked on a specific frequent flier program, insist on getting flight information about their regular carrier even when others offer lower fares or more convenient schedules. Experienced travelers are the heaviest users of airline services – less than 10 percent of air travelers account for more than 40 percent of all air trips. And they are undoubtedly aware of alternative carriers.

These same arguments suggest that costs to travelers arising from travel agent commission overrides – the airline practice of paying premium commissions to travel agents who steer extra business their way – have been minimal. For one thing, agencies that book travel for corporate clients run a serious financial risk if they fail to book flights that match travelers' stated preferences. For another, airlines are encouraging travelers to bypass travel agents entirely and book on their own Web sites.

Five major U.S. carriers recently announced plans to start T2, the largest one-stop travel site on the Web. The Justice Department is now investigating whether T2 violates antitrust laws. But the ongoing competition from independent discount airline ticket sellers and independent Web-based travel sites should mollify these concerns.

Collusion. Collusion is harmful to travelers if it allows carriers to raise fares above what they would have been if they had been set independently. Of particular interest in the airline industry is "price leadership," whereby an airline proposes a fare change, sees if other airlines follow its lead and then reacts accordingly. During the early 1990s, the Department of Justice grew concerned that the centralized airfare database maintained by Airline Tariff Publishers was being used by carriers to signal other carriers about their fare plans. In 1994, after an investigation, several carriers signed a consent decree that required them not to post ending dates – the likely signal – for their fare filings. But we found that the decree has had no measurable effect on fares.

In theory, airlines could also engage in extensive cooperation and tacit collusion if they share many routes. To the extent that a large part of a carrier's revenue is earned in markets in which it competes with another carrier, both have strong incentives to collude. Such multimarket contact also makes it easier for them to monitor each other's fares and to detect deviations that are directed toward them. As a practical matter, though, tacit collusion is extremely vulnerable to hard economic times and thus may have the opposite effect.

During the late 1980s, for example, multimarket contact did lead to higher fares. But when the industry's fortunes declined in the early 1990s, carrier rivalry intensified and

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multimarket contact led to intense fare wars. Our recent research indicates that multimarket contact continued to reduce fares into the late 1990s.

Mergers. Mergers are an extreme form of collusion. During regulation, airlines' merger requests were almost always denied unless the merger was designed to keep one of the carriers from going bankrupt. Few mergers have been blocked since.

We found that carriers are generally not motivated to merge for anticompetitive reasons. The leading explanations for mergers since deregulation seem to be a desire to expand international routes and to relieve financial distress. Major mergers during the 1980s that some policymakers thought would raise fares – notably Republic-Northwest and TWA-Ozark – proved benign. By the same token, we doubt the proposed United-US Airways merger would undermine competition.

JAN HAKAN DAHLSTROM/PHOTONICA

Frequent Flier Programs. The major carriers developed frequent flier programs in the early 1980s as a competitive response to new low-fare carriers like People Express. Today, some observers believe that these programs enable large airlines to fend off new competition both because their large route structures make free trips more valuable and because they give heavy business users seeking service upgrades a powerful incentive to remain loyal to a single carrier. Indeed, there have been several proposals in Congress to tax frequent flier mileage to limit the competitive advantage – a political nonstarter in light of the size and affluence of the group that would be affected.

In any case, smaller carriers do not appear to need such measures. They can and have offset the competitive advantages of frequent flier programs by charging lower fares and developing customer loyalty with better service. If they wished, smaller airlines could probably imitate credit card companies, purchasing and doling out frequent flier miles that could be redeemed on major carriers. The fact that few do suggests that the anticompetitive effects of mileage programs have been exaggerated.

Predatory Behavior. Critics have been accusing airlines of trying to drive out competitors for more than a decade. But no carrier has ever been found guilty of predation. To facilitate action, in the spring of 1998 the Transportation Department issued guidelines that identified the pricing and capacity responses by a major carrier after the entry of a smaller carrier that would precipitate formal proceedings.

But defining predatory behavior, let alone measuring it, has proved very difficult for courts, regulatory agencies and even ivory tower types. In our research, we took the Transportation Department on its own terms, analyzing routes where the agency

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claims predatory behavior is likely to have taken place during the fall of 1998 as well as routes where predatory behavior is likely to have taken place but ceased by the fall of 1998. As expected, we found that average fares fell while predatory behavior was occurring. But we also found that fares did not rise above their pre-predatory levels when an alleged instance of predatory behavior had ended – implying that consumers ended up ahead.

To be sure, carriers may have engaged in predation on routes where fares were extremely profitable, so that they did not have to raise fares above pre-predatory levels after driving out a competitor to benefit from this strategy. Indeed, we found that fares on the routes in question were 12 percent higher than on comparable routes. This difference, however, amounted to only $20 million annually – less than the fare savings that travelers enjoyed during the skirmishes.

Will large carriers be rewarded with a "quiet life" on these routes and possibly others because they have discouraged new entry? Ask Northwest about ProAir, Spirit, and Sun Country; ask United about Frontier – and ask everyone else about Southwest and JetBlue.

There have been several proposals in Congress to tax frequent flier mileage to limit the competitive advantage – a political nonstarter in light of the size and affluence of the group that would be affected.

TIME FOR BENIGN NEGLECT?

With benefits from deregulation and the dispersion of deregulated fares fairly stable for nearly a decade, why have policymakers stepped up their involvement in the airline industry in the past few years? Congress, the Justice Department and the Transportation Department have been responding less to the general interests of travelers than to the specific interests of competitors and organized groups of travelers. For example, an effective campaign for new airlines by lobbyists, business travelers and small cities paved the way for the Transportation Department's competition guidelines. More recently, the American Society of Travel Agents and Microsoft's Expedia asked the Justice Department to investigate the major carriers' T2 venture.

Although zealous policymakers have yet to institute new measures that seriously compromise air transportation's efficiency, they have certainly not discouraged efforts to use the government as a way to overturn decisions by the market. Moreover, the perception that the government can be used to pursue economic "rents" has encouraged a lingering regulatory mind-set in the airline industry. With the government not yet focused on public welfare, carriers are not yet completely focused on being as efficient as possible.

Responding to the airlines' $12 billion in losses in the early 1990s, President Clinton formed a national commission to investigate whether the deregulated airline industry was capable of achieving financial viability. In the

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end, the commission took no real action, and the industry achieved record profitability a few years later.

Our concern is that in reacting to "crisis" after "crisis," whether it concerns the plight of airlines or their passengers, policymakers risk instituting policies that hurt both. At the very least, they are diverted from more fundamental problems in which government could intervene constructively.

A PARTING AND FOND FAREWELL

The cyclical nature of the airline business from boom to bust affects the carriers' financial performance and is likely to draw the ire of a vocal minority of travelers for the foreseeable future. But more than 20 years after airline deregulation, it is time to start thinking about a long-run policy equilibrium. What steps (if any) should government take to enhance competition in the deregulated environment so that carriers focus entirely on becoming as efficient as possible?

Airport access. During the 1950s and 1960s, airlines agreed to stand behind billions of dollars in revenue bonds needed for airport expansion. In return they received leases that gave them exclusive use of gates. During the era of regulation, such exclusive long-term leases on gates were innocuous because carriers were prevented from entering other routes. But in the deregulated airline industry, exclusive-use leases have effectively given carriers a lock on airport access. We estimate that the scarcity of gates at several large and mid-size airports has raised fares and lowered travelers' welfare by $3.8 billion annually.

By the same token, travelers have also been hurt by delays, which airports could ameliorate with efficient (congestion-based) takeoff and landing tolls and making appropriate investments in runways and terminals.

Infrastructure Privatization. The Federal Aviation Administration has been criticized for decades for its failure to modernize air traffic control equipment and operations. Most recently, the FAA has been faulted for delaying the introduction of Global Positioning System technology, which could expand runway and airspace capacity by enabling carriers to choose speedier flight paths and to take off and land more quickly.

One plausible solution is to bring in the private sector. In 1996, Canada handed its air traffic control system over to Nav Canada, a private company. Nav Canada has lowered the cost of flying, upgraded the system's technology and increased the number of flights handled per employee. The company's board of directors is drawn from commercial carriers, general aviation and labor, and it has sought to be responsive to the system's users. It could serve as a model for the United States.

Researchers have yet to make a full analysis of airport privatization, but its appeal is obvious. Under the current system of public ownership and management of airports, incumbent carriers are able to block proposals to expand the availability of gates while owners of corporate jets and small planes block congestion-sensitive takeoff and landing tolls.

Meanwhile, the legal and political wrangling that an airport must go through to build new runways discourages most from even considering capacity expansions. Changing the environment so that airports are more subject to market discipline and are less exposed to political constraints could make a big difference.

The bottom line, then, is clear enough for those who care to see it: airline competition works. The real threat to competition is coming from underinvestment in infrastructure and – as important – a lack of incentives to use the available infrastructure efficiently. Is anybody in Washington really interested?

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the Marriage is Working

By Marsha Vande Berg

A new United States-Mexico relationship is taking shape – one based on pragmatism in the north and an expectation of sustainable growth in the south. While any number of imponderables could still skew the outcome, three factors suggest that both sides have passed the point of no return on the integration of their economies. First, the transition in political power that started with Mexico's presidential election in July and will continue with the United States's contest in November is unlikely to threaten the momentum built around cross-border trade and export-led growth in Mexico. Second, while

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the two economies remain vastly different, they are becoming interdependent. And third, it is likely that the Internet will become an effective bridge between Mexican-Americans' tastes and south-of-the-border traditions.

That is not to say problems won't continue to crop up, particularly if the United States economy wobbles. Nor does it imply that Mexico has rid itself of the corruption in high places that has soured joint efforts to attack drug trafficking. But one can be fairly confident that these squabbles will no longer become front-line diplomatic skirmishes.

The North American Free Trade Agreement, which took effect in 1994, was the turning point. With Nafta, United States business secured virtually tariff-free access to a market of 95 million people, as well as to a low-cost industrial labor force with a strong work ethic.

Other benefits from the tie may be less tangible, but no less important. The treaty marked the first time that a developing country established equal footing in a trade relationship with two very powerful, wealthy and developed nations – the United States and Canada. And in the process, Mexico got the opportunity to shed its status as victim. "It's not often we see national cultures break out of the mold formed by centuries of history," said M. Delal Baer, chairman of the Center for Strategic and International Studies' Mexico Project in Washington, "but the passage of Nafta has brought truly a paradigmatic change in United States-Mexican relations."

Baer told a Senate committee that "Mexico began to see its location next to the largest market in the world as more of an opportunity than as a problem. And the United States began to see Mexico as a commercial opportunity rather than a source of immigration and drug problems."

Likewise, the agreement gave Mexico a boost in reforming its own economic and social scene. Largely because of Nafta, Mexico has undertaken a makeover of its crony economy, emphasizing entrepreneurial enterprise, greater social equality and job creation. And it has begun to take on social reform – notably, the 1997 pension reform.

When Ernesto Zedillo became president in 1994, he set in motion a variety of reforms that today form the centerpiece of his legacy. Even though those reforms are taking hold

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unevenly, Zedillo's successor, Vicente Fox, the brash former governor of Guanajuato Province and Coca-Cola executive, is expected to continue to try to narrow the distance between rich and poor, providing jobs and better education, and increasing the size of the country's exports.

Fox and his National Action Party (PAN) defeated Institutional Revolutionary Party (PRI) candidate Labastida Ochoa on July 2 in a stunning upset that ended the PRI's iron grip on Mexican government for the last 71 years. The vote did not alter PRI's control of two-third's of the country's governorships, but it did signal a new confidence in the country's ability to act on electoral reform and to abandon the reliance on a one-party system. This in turn is likely to work to the benefit of an improved relationship with its key Nafta partner.

If the new Mexican administration falls short, disappointment will be keen both inside Mexico and north of the border. Failure would raise red flags at the border over the prospect of more migration out of Mexico. And missing the economic mark too widely would humiliate Mexicans by thrusting them back into the shadow of the colossus to the north.

"In my view, politics is every bit as important as the economics of reform – because if we don't get the politics right, we never will get change right," said Robert E. Rubin, the former secretary of the Treasury, addressing a recent forum on Mexico and Latin America at the Council on Foreign Relations. If the economy is put to the test – and "Latin America will be tested again," Rubin warned the group – there is every danger that the commitment to reform will flag and those who fall by the wayside will be the poor.

On the nuts and bolts level, Nafta has eliminated most restrictions on the flow of goods, services and investments. It also wiped out a number of nontariff barriers and secured legal rights to intellectual property. By no coincidence, cross-border trade has almost doubled since 1994, to just under $200 billion today. United States companies now sell more to Mexico than to any other country except Canada – and Mexico sends more than 80 percent of its export northward, replacing Japan as America's number two source of imports.

It also means that, since 1994, United States business has poured tens of billions of dollars into job and wealth creation, particularly into the foreign-owned, export-oriented factories that have proliferated in Mexico's northern states. And the Americans are not alone. The Europeans, as well as the Japanese, are making a point of increasing trade with Mexico.

With Nafta's wind at its back, Mexico is negotiating one trade pact after another. An agreement recently struck with the European Union is patterned after Nafta. There is also

MARSHA VANDE BERG writes *The World Report*, a newsletter on global economics.

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an agreement with Israel and another in the offing with Japan, Mexico's third-largest contributor of foreign direct investment.

Mexico also is positioning itself to be a Central American trade heavyweight. A trade agreement with Guatemala, El Salvador and Honduras ended four years of contentious relations in Mexico's backyard. Indeed, the pact represents a significant step forward in Mexico's plan to create a "Meso-America" that reaches as far south as Panama.

These agreements indirectly benefit foreign enterprises already in place in Mexico. For example, Yankee automakers have invested $11 billion in Mexico since 1990. And after Nafta kicked in, they started cultivating Spanish-speaking suppliers who help them connect with regional players beyond Mexico's borders.

Mexico's newfound focus has boosted it from 26th place in 1993 to 8th place in today's pantheon of world exporters. If the momentum is maintained, this once-insular country will complete the transition to a flexible, diversified exporter of industrial products.

PARALLEL PRESIDENTIAL POLITICS

Domestic issues are the name of the game in presidential politics this year. That is true for Mexico and, of course, the United States as well. In both cases, cross-border matters are playing a distant second fiddle to a variety of domestic concerns.

Vicente Fox, the newly elected president of Mexico, is not expected to alter the course of relations with the United States. But problems could crop up later this summer, because the new president does not take over until mid-November. "That's a time that is ripe with opportunity for volatility and danger," said Artura Valenzuela, a National Security Council adviser on Inter-American Affairs.

TWO ECONOMIES, TWO SPEEDS

There are other potential problems, not directly linked to the elections. "A 1 percent fall in United States GDP growth would lead to a $4 billion to $5 billion drop in Mexican imports and severely affect direct foreign investment into Mexico," a Deutsche Bank analyst wrote recently. Or, to paraphrase the hoary joke, if Uncle Sam sneezes, Mexico catches pneumonia. But the prognosis for pneumonia is no longer as grave: the country's flexible-exchange rate regime, and its improved economic fundamentals provide "an adequate buffer" against unsettling external factors, Deutsche Bank added.

Earlier this year, Moody's Investment Service decided to raise Mexico's credit rating to investment grade – a first for the country. Around the same time, the Mexican Investment Board reported that international companies are expecting to funnel $12 billion this year in direct investment into Mexico, $1 billion more than last year. The United States and Canada lead the pack.

Meanwhile, reforms are proceeding – albeit with stops and starts. Two news items illustrate the extremes at play with banking

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reform. On the one hand, Mexico agreed to let a Spanish bank, Banco Bilbao Vizcaya Argentaria, take the reins of Bancomer, the country's second-ranked financial group, for $1.2 billion. The acquisition marked the first time foreigners have been permitted to enter the inner sanctum of Mexican private finance.

On the other hand, reform rings hollow if it is not applied with consistency. When the Mexican government decided to prepay a $2.5 billion promissory note held by Citibank, the move brought scorn from some quarters because it seemed to be part of a cozy arrangement in which Citibank agreed to buy Confia, a Mexican bank loaded with bad debt. "The affair underlines the need to conduct relationships with the banking sector on consistent and transparent basis and avoid discretionary deals with individual banks," the *Financial Times* editorialized.

TWO CULTURES, ONE LANGUAGE

Nafta is not simply Americanizing Mexico, wrote Jorge Castaneda in his insightful *Limits to Friendship: The United States and Mexico.* The United States is changing, along with its partner, he said, and both societies "are moving toward something new – something that in the long run may provide a global cultural consensus within which a wide variety of cultures can coexist harmoniously."

The Internet is likely to be an important catalyst to this change, particularly if the efforts of StarMedia Network succeed. StarMedia is the first media company focused on Latin America to be traded on Nasdaq. It provides news, e-mail, chat groups and other forums for Spanish- and Portuguese-speaking audiences worldwide. "Whether it's Web sites or e-commerce, Mexico is looking at a gigantic opportunity to get connected with the United States' Spanish-speaking market, and vice versa," said Andriana Kampfner, the president of StarMedia Mexico.

The Mexican business community, which so far has "not been as aggressive as other places when it comes to e-commerce," will eventually mend its ways, out of sheer need to compete, she predicted. Individuals, too, particularly the 17- to 34-year-olds who comprise Mexico's fastest growing population segment, will start pushing for greater and more affordable access, she added.

The numbers suggest that Kampfner is reading Mexico right. New York-based Jupiter Communications predicts that Mexico's e-commerce will jump from $25 million last year to $1.54 billion by 2005. By then, 4.3 million Mexicans are expected to be surfing the Net. The International Data Corp. reports that Latin America had the world's fastest growing computer sales last year. Computer shipments to Mexico grew by 30 percent, to 977,000.

In separate interviews, StarMedia's Kampfner and Fernando Espuelas considered StarMedia's possibilities in light of one major hurdle: accessibility and affordability in the face of the country's recently privatized telecommunications system. With privatization,

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Telefonos de Mexico, known as Telmex, became the country's largest business, continuing to provide local, cellular and long distance service. It retained the right to set fees for access to its telephone lines. This stranglehold has since prompted two United States carriers, MCI WorldCom and AT&T, to complain about high connecting fees.

The United States Trade Representative's office has put Mexico at the top of the list of countries that have erected trade barriers in the area of telecommunications. Meanwhile, the Federal Communications Commission and the Organization for Economic Cooperation and Development in Paris have piled on with their own objections.

While the battle nominally is about market access, the issue of affordability is at the heart of these actions. The Internet's built-in advantage, argues Kampfner, is its potential to drive people to demand access to tools they learn about from others and feel they deserve – whether they are living in Monterrey or Minneapolis.

Espuelas makes a similar point. "My vision is a rapidly technifying society, and it will drive the rest of industry and education," he said. "Plus, we are moving away from a monopoly by the telecoms" in Mexico and throughout Latin America.

There is another aspect of the United States-Mexico relationship that casts a long shadow over the others: Some 10 million Mexicans and Mexican-Americans live legally in the United States, a number of immigrants far larger than the great migrations from Ireland and Italy produced.

Two-thirds of the United States' Latino population are Mexicans, and nearly 20 percent of all babies born in the U.S. are Latin. By 2050, 25 percent of all residents will be Latino. In Texas, people of Mexican origin are expected to achieve a plurality within five years. In California, the Mexican-American population now equals a quarter of the state's 33 million residents.

These Mexican-Americans form the backbone of an increasingly vocal Hispanic community. Mexicans are also a primary source of growth in the American labor force. "Visit any hotel, restaurant, landscaping business or construction site – whether new homes are being built or road work is being done – and a majority of the workers are likely to be Mexican," *The Dallas Morning News* reported.

A QUID PRO QUO

One of the bright results of domestic reforms is that Mexico "is exporting fewer people," said Luis Teller Kuenzler, Mexico's Secretary of Energy, a trend he credited to Nafta's wake-up call to change.

That is music to ears on both sides of the border. Mexico wants a reformed economy with greater sustainability. For its part, the United States wants a prosperous and confident neighbor that is equally committed to cross-border cooperation. In other words, both countries want and need something from the other. Nafta is working. M

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Worthship to Know about Estate Taxes

By William G. Gale and Joel B. Slemrod

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In pondering the Stamp Act passed by the British Parliament in 1765, Benjamin Franklin famously asserted that "in this world, nothing is certain but death and taxes." Two centuries later, recent advances in corporate tax shelters and cryogenic prolongation of life notwithstanding, Franklin's assertion remains uncontroversial. However, the decision to impose taxes that depend on death is a policy choice, not a certainty.

The idea of making death a lucrative event for tax collectors infuriates some people. Steve Forbes campaigned in favor of "no taxation without respiration." Bruce Bartlett, a senior fellow at the National Center for Policy Analysis, points out that the abolition of inheritance rights was a key plank in the Communist Manifesto. In economic terms, the estate tax is alleged to reduce aggregate capital accumulation, wages, jobs and economic growth; to destroy small businesses, farms and the environment; to treat frugal households unfairly compared to spendthrifts, and to support an army of attorneys that generates huge compliance costs and ingenious avoidance strategies.

Others might feel entitled to ask what all of the fuss is about. The tax is levied on the estates of fewer than 2 percent of Americans upon their death and it raises less than 2 percent of federal revenues. Under current law, a married couple with wealth of less than $1.35 million need pay no tax upon death. And that figure is slated to rise to $2 million by 2006.

In addition, the wealthy can make significant tax-free gifts to their descendants, and unlimited tax-free gifts to non-profit organizations. Special provisions generously address the needs of small businesses and farms. As a result, half of estate and gift tax payments are made by decedents with estates in excess of $5 million, who account for only one out of every 1,000 deaths in the United States. Thus, supporters argue, the estate tax is a highly progressive and relatively cost-effective way to raise revenue. And they say the tax has other social benefits too, breaking up large concentrations of wealth and encouraging giving to charitable causes.

Besides its association with the rich and the dead – two boundless sources of fascination – the estate tax raises a number of intriguing issues. First, it highlights the pervasive trade-off between equity and efficiency in the design of government policy. There is a prima facie case that the tax is progressive, since it is levied only on the wealthiest households. On the other hand, the tax base is closely tied to accumulated wealth. So there is also a prima facie case that the tax reduces the labor supply, effort and savings that create wealth and are crucial for prosperity.

In addition, the estate tax tests our views on the rights of parents to provide for their offspring. Some bequests are motivated by altruism, some might be considered a form of payment for services that children provide. And some are undoubtedly an afterthought, in that they were intended to provide for the parent's expenditures, but the parent died before consuming the funds. Each alternative provides different implications for the right way, if at all, to tax estates.

To jaded viewers of seemingly endless and predictable policy debates between liberals and conservatives, the estate tax offers a few surprises. It's true that most liberals support the tax and most conservatives oppose it, all for the usual reasons. But some liberals, such as attorney Edward McCaffery, of the University of Southern California, vocifer-

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BILL GALE is a senior fellow at the Brookings Institution. **JOEL SLEMROD** teaches economics at the University of Michigan Business School.

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ously oppose the tax. McCaffery believes it encourages more of the rich to consume rather than to save. And some conservatives, notably Irwin Stelzer of the Hudson Institute, enthusiastically support near-confiscatory estate taxes. Stelzer argues that allowing large inheritances is basically affirmative action for rich kids – which, as a good conservative, he opposes. Plainly, their analyses cut across the partisan fissures that traditionally demarcate policy debates.

What's more, the estate tax is a hot issue in this electoral season. Last year, in a vote split along partisan lines, Congress voted to phase out the estate tax over the next decade. President Clinton vetoed the bill. In June of this year, though, 65 Democrats in the House joined Republicans to vote the tax out again. Presumptive Republican presidential nominee George W. Bush advocates repeal as well. As of this writing, the bill has not been voted on in the Senate.

To jaded viewers of seemingly endless and predictable policy debates between liberals and conservatives, the estate tax offers a few surprises.

Even if the estate tax issue dies after the election, it won't be out of sight for long. Almost everyone concedes the need to reform the existing laws, especially in light of the fact that the aging of the population and the stock market boom will sharply increase the amount of estate assets subject to taxation in the future.

HOW IT WORKS

History

Taxes on transfers of wealth were levied as far back as the 7th century BC in Egypt. The first American tax on wealth transfers dates to 1797 when, faced with the expense of dealing with French attacks on American shipping, Congress imposed a stamp duty on receipts for legacies and probates for wills. The tax was eliminated in 1802. Similar, short-lived taxes were enacted during the Civil and Spanish-American Wars. The modern estate tax also originated in a time of war preparation, if not war itself, in 1916. However, this incarnation survived World War I because it fit the dominant view of the time that federal revenue from customs and excise taxes should be replaced by more progressive taxes.

Current Law

The laws that govern how and to whom property may pass are the exclusive domain of the states. Each state regulates how property may be transferred to heirs, and the extent to which family members, principally spouses and children, are protected from disinheritance. In contrast, federal law governs the taxation of such transfers, although states may also impose estate or inheritance taxes. The executor of an estate must file a federal estate tax return within nine months of the death of a U.S. resident if the value of the gross estate exceeds $675,000. The unified federal estate and gift taxes apply a single graduated rate schedule to cumulative lifetime taxable transfers made by an individual during life or at death.

The first step in determining estate tax liability is to calculate the value of the gross

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estate. Gross asset value is sometimes difficult to determine, and, in particular, closely held businesses are allowed to value assets as they are deployed in the existing business (say, land in farming) rather than their market value (say, as subdevelopment). In addition, it is often possible to discount the valuation of assets by placing them in an alternative ownership form, such as a family limited partnership, rather than holding them directly. In order to prevent avoidance of the tax through gifts made during life, the tax base also includes gifts made by the decedent in excess of an exemption of an annual $10,000 per donee.

The next step is to determine the taxable estate – the difference between gross estate and allowable deductions. All transfers to a surviving spouse are fully deductible, as are contributions to charitable organizations. Deductions are also allowed for debts owed by the estate, funeral expenses, and administrative and legal fees associated with the estate. A limited credit against tax liability is given for state-levied inheritance and estate taxes. Most states now levy so-called "soak-up" taxes that fall within the credit limit, so that they transfer revenue from the federal to the state treasuries without adding to the total tax burden on the estate.

The unified credit currently exempts taxes on the first $675,000 of lifetime taxable transfers per individual, a figure that will rise to $1 million by 2006. For estates larger than that, the tax rate begins at 37 percent and rises gradually until it is 55 percent on taxable transfers above $3 million. For estates that are predominantly closely-held businesses, the tax payments can be spread out over 14 years, with the first five years' payments covering only interest at below-market interest rates on the taxes owed.

Who Pays?

In 1999, the federal estate and gift taxes collected $28 billion. This compares to the $879 billion raised by the individual income tax and the $185 billion raised by the corporation income tax. The increase in personal net worth fueled by the boom in the stock market and real estate values suggests that the estate tax, even with the legislated gradual increase in the exemption level, will grow in relative importance as a revenue raiser, although the projections of the Congressional Budget Office do not reflect this.

In 1997 estates with gross value over $5 million accounted for nearly half of all estate tax revenues, but only one out of every 1,000 deaths.

Estate tax liability is extraordinarily concentrated among high-wealth families. In 1997 estates with gross value over $5 million accounted for nearly half of all estate tax revenues, but accounted for only about 5 percent of all taxable estates and about one out of every 1,000 deaths. The average tax payment for these estates is $3.5 million. Although the marginal tax rate reaches 55 percent, the average tax rate (tax divided by gross estate) in this group is less than 19 percent, reflecting the exemption and graduated rates, as well as the deduction for charitable and spousal bequests. In contrast, the 85 percent of taxable estates with a gross value below $2.5 mil-

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lion account for only 30 percent of estate tax revenues, and have paid an average tax rate of about 13 percent.

To highlight this concentration, one can also classify tax burdens according to household income. The U.S. Treasury Department has calculated that households in the top 5 percent of the income distribution bear 91 percent of estate taxes, compared to 49 percent of income taxes. Households in the top 20 percent of the income distribution bear 99 percent of estate taxes, compared to 77 percent of income taxes. Thus, the estate tax is considerably more progressive than the already-progressive income tax.

Among the top 5 percent of households, estate taxes are the equivalent of about 6 percent of income taxes. Thus, abolishing the estate tax would amount to a permanent 6 percent reduction in income taxes for this group. Lest you worry that the Treasury has cooked its analysis, an independent analysis published in 1997 by Daniel Feenberg, Andrew Mitrusi and James Poterba for the National Bureau of Economic Research reached about the same conclusion.

THE ISSUES

Controversy concerning the estate tax touches on a wide variety of topics. Here, we try to keep score of the various issues. In the next section, we link the various arguments made to specific proposals for change.

1. The appropriateness of imposing taxes at death. Opponents of transfer taxes often view death as an illogical time, at best, to impose taxes, and a morally repugnant time, at worst. Compounding the grief of a family with a tax seems a bit heartless, to be sure, and it is this queasiness that the opponents play on by labeling the estate and gift taxes the "death tax." Evocative as it is, this label is seriously misleading. First, death is neither sufficient nor necessary to trigger the estate and gift taxes. It isn't sufficient because fewer than 2 percent of decedents pay any tax. It isn't necessary because gifts between living people can trigger a tax liability.

Second, estate tax liabilities can be effectively pre-paid via life insurance purchases tied to the expected tax liability or, in the case of qualified family businesses, can be delayed and paid over a 14-year period after the death of the owner. Thus, although death may trigger the tax liability, the payment can be remitted at any of a number of milestones.

Third, at least some component of estate tax payments – for example, payments on unrealized capital gains – can be thought of as a "final settlement" with respect to the income tax. Such taxes would be triggered by death even if the estate tax were abolished and replaced with taxation of previously unrealized capital gains income at death.

Leaving the morality issue aside, death is very likely to be a convenient "tax handle." The public nature of probate can reveal information about a family's wealth that is difficult to obtain in the course of enforcement of the income tax. This aspect of taxation at death likely explains why inheritance and estate taxes date back for millennia. Many economists, in fact, have argued that taxes payable at death are preferable to taxes paid during life, because the former have smaller disincentive effects on lifetime labor supply and savings than do equivalent-revenue taxes imposed during life. For all of these reasons, turning a tragic but inevitable life event into a taxable event may be off-putting, but it is perfectly sensible from an administrative perspective.

Finally, it is worth noting that much of the hostility focused on so-called death taxes is simply disingenuous. Note that no opponent of estate taxes objects to the fact that income

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taxes are due on 401(k) and IRA balances at death. Nor do any of the opponents suggest that, in exchange for eliminating estate taxes, they would support increased taxes on the wealthy during life – though the latter, of course, would be the logical solution to the particular problems created by taxation at the time of death.

2. Progressivity. Progressivity has been the traditional justification for the highly graduated estate tax and remains the principal defense now. However, one might reasonably ask why the desired degree of progressivity couldn't be achieved solely through the income tax. The answer usually given is that the capacity of the income tax to impose progressive burdens is limited by several factors, notably the preferential treatment of capital gains. Capital gains are taxed at a lower rate than other capital income. And they are taxed only when the underlying assets are sold, as opposed to when the gains accrue. Most important, gains are excused from income taxation at death.

Certainly the standard liberal defense of the estate tax on progressivity grounds is in part a knee-jerk resistance to a tax change that primarily benefits the most well-to-do. On the other hand, the standard conservative attack on the estate tax is partly a knee-jerk response to any tax that is progressive – witness the criticism over the last few years on the graduated income tax and capital gains taxes, support for the flat tax, and so on. Neither liberals nor conservatives, though, are arguing for a low-exemption, flat-rate estate tax that would be paid by almost everyone upon death.

Instead, the policy debate concerns a tax that applies only to the rich. It would help if opponents of the estate tax clarified whether they are advocating a large reduction in the progressivity of the tax burden, or just a change from one progressive tax instrument to another. Likewise, it would help if supporters of the estate tax clarified whether they would support an equally progressive alternative tax, or whether there is something about taxation of wealth transfers per se that is essential.

3. Backstopping the income tax. Supporters of the estate tax often note that it serves as a backstop for the income tax, imposing taxes on income that escaped taxation during life. As noted above, unrealized capital gains that are inherited receive a "basis step-up" and thus never face income tax. The basis step-up ensures that even though the asset may have appreciated in value over the lifetime of the donor, the recipient is exempt from capital gains taxes on the appreciated value of the inheritance. It is worth noting, too, that this basis step-up also occurs for transfers from one spouse to another, even though such transfers are deductible from the gross estate. As a result, the estate tax contains a very large marriage bonus.

To the extent that the estate tax is meant to capture tax on previously accrued but unrealized capital gains, the tax should apply only to unrealized capital gains and should be capped at the highest capital gains tax rate. Needless to say, that is not what the estate tax looks like, now or in the past.

4. Concentration of wealth. From its beginning the estate tax was viewed as a counterweight to an undue concentration of wealth. These days some opponents claim that the estate tax fails to achieve this goal. True enough, it isn't obvious that the concentration of wealth is less in the era of high estate taxes than it was before. But the real question is whether the concentration of wealth is less than it would be in the absence of the tax.

It is probably unrealistic to expect a tax

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that raises revenue equal to just 0.3 percent of GDP and just 0.1 percent of household net worth in a typical year would make a serious dent in overall wealth inequality. Small programs typically have small effects. This reduces the scale of both costs and benefits, but doesn't settle the argument about whether the benefits exceed the costs. In fact, the opponents' claim could be construed as an argument for increasing, rather than decreasing the tax.

5. Effects on savings, labor supply and economic growth. Combined with the income tax, the disincentive to work and save created by the estate tax for the affluent can be exceptionally high. The top federal income tax rate of 39.6 percent combined with the top estate tax rate of 55 percent implies that the tax penalty of a dollar earned with the intent to bequeath is taxed at an effective rate of almost 73 percent.

In the 18th and 19th centuries there was a lively discussion among such luminaries as Adam Smith, David Ricardo and J.B. McCulloch as to whether an estate tax was a serious hindrance to saving, and therefore to capital accumulation. The debate focused on whether a tax liability due so far in the future, and attached to an event many people prefer not to think about, could really be a disincentive to activities undertaken in the prime of life. Ricardo (who was very rich) thought the tax was a disincentive; McCulloch and others disagreed.

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Today, this issue remains controversial, but now revolves around the question of what motivates people to give bequests, which turns out to be critical in sorting through the impact of an estate tax on savings rates. Consider the implications of bequests that are unintentional or accidental – bequests that arise from people's unwillingness or inability to convert their wealth to a guaranteed lifetime earnings stream that they can not outlive. In that case, an estate tax would not be a disincentive to save, and would further not burden the bequeathor (although the donee would be less well off, to be sure). And what if bequests are really payments for services rendered by children to parents in their later years? Then an estate tax merely raises the price of purchasing such services. The bottom line: since people are likely motivated by a combination of factors in their bequests, the impact of estate taxes on saving by the estate owner is difficult to sort out.

As it is difficult even to determine whether a tax would have a positive or negative impact on the donor's saving, we must rely on statistical evidence for insight. But direct evidence of the impact of estate taxes on these decisions is sparse. Indirect evidence from analyses of the effects of income taxes on labor supply and savings is of course relevant, and in both cases the bulk of the evidence suggests that the effect is small. Estate taxes are levied at higher rates than income taxes, which might suggest a larger effect. But they are also levied at more distant points in the future, suggesting smaller effects.

Over the history of the U.S. estate tax, it does seem to be true that in years when estate tax rates are relatively high, reported estates as a fraction of national wealth are lower than otherwise. This pattern is consistent with either a depressing effect on wealth accumulation or an stimulative effect on estate tax avoidance – or both. However, closer examination of estate tax returns reveals that this association is statistically fragile, so we are still without any hard evidence that capital accumulation has been undermined.

The discussion above focuses on saving by the donor. But evidence shows that large inheritances reduce the work effort of recipients (consistent with Andrew Carnegie's famous conjecture) and raise their consumption, too. Thus, to the extent that the estate tax reduces net-of-tax inheritances, it can raise saving by the recipients.

Ultimately, the progressivity of the tax depends on its impact on savings and labor supply. Because the impact appears to be relatively small and uncertain, we feel it is appropriate to maintain the view that the estate tax is progressive until new evidence is provided.

6. Family-owned businesses and farms. Even if the estate tax does not affect the level of savings, it could well affect the ability of family businesses and farms to survive their owners' deaths. These issues have received a lot of attention, in part because of the inordinate political importance of Iowa in the presidential election process, more generally because of the political visibility of farmers and small businesses. Estate tax opponents claim that a large proportion of American businesses never make it to second generation owners and assert that the estate tax is the reason why.

This is surely a case of the tail wagging the dog. There are many reasons why businesses do not pass from one generation of a family to another. Because only a very small portion of small businesses and farms ever even pay estate taxes, it is unlikely that the estate tax has a very important impact on the proportion of businesses that make it to the second

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generation or beyond. In 1997, farm assets were reported on fewer than 6 percent of all taxable estates, and farm assets totaled a microscopic 0.3 percent of taxable estate value. For small businesses, the figures are larger, but still not very significant. Fewer than 10 percent of taxable returns in 1997 listed closely held stock, which accounted for only 7 percent of taxable estate value. Limited partnerships and "other non-corporate business assets" accounted for an additional 2.7 percent of taxable assets.

Thus, using a very expansive definition, farms and small businesses account for at most 10 percent of all assets in taxable estates. And farm and small business assets constitute a majority in only 3 percent of taxable estates. People who own neither farms nor small businesses pay the vast majority of estate taxes. This implies that scaling back or eliminating the estate tax is a very blunt instrument for dealing with this issue.

Moreover, family farms and businesses already receive special treatment under the estate tax. Taxpayers can calculate the taxable value of family farms and businesses on the basis of their worth to family proprietors (rather than their market value). Use of the mandated formula can reduce a gross estate by up to $775,000. In addition, the estate tax due on family farms and businesses can be paid in installments over a 14-year period with only interest payments due in the first five years. Legislation enacted in 1997 permits a special deduction of up to $675,000 worth of family-owned farms and businesses when they constitute at least 50 percent of an estate and in which heirs materially participate.

On top of all that, recall that small businesses already receive numerous tax subsidies, under the income tax as well as the estate tax. In addition, an estimated two-thirds of the value of family-owned businesses consists of unrealized capital gains that have never been taxed under the income tax. Exempting it from estate tax as well would provide an even larger subsidy to small businesses. No convincing case has ever been made for the current level of subsidies, much less for expanding them.

Opponents claim that a large proportion of businesses never make it to second-generation owners and assert that the estate tax is the reason why. This is surely a case of the tail wagging the dog.

7. Fairness. While progressivity issues focus on the treatment of those with higher income or wealth, another component of fairness focuses on how "equals" – different households with the same income or wealth – are treated relative to each other. There are many difficult issues along these lines that arise with the estate tax.

For example, estate tax opponents claim that the tax inequitably burdens families that are altruistic compared with those that are selfish, and punishes those that are unwilling or unable to engage in sophisticated tax planning to avoid the tax. To be sure, the estate tax is a tax on just one way to dispose of one's wealth. Comparing two families of the same

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(considerable) means, the tax would not burden the one that chooses to spend every penny on themselves, or even the family that gives it away to charity, but burdens only those families that pass their good fortune along to their own.

Put this way, it seems to violate principles of equity to single out families that are generous to their own children or grandchildren. Edward McCaffery stresses this "horizontal" inequity of the estate tax. Many economists would also argue in favor of intergenerational giving because the bequest provides satisfaction to the giver, as well as to the receiver.

Perspective, however, is crucial to this argument. From the point of view of the giver, the tax seems to single out the altruistic for taxation, leaving the squanderers untouched. But from the perspective of the next generation, inheritance provides an advantage to some rather than others. Supporters of the tax claim that advantages so derived are unearned and unfair. They claim that inheritances provide large benefits to people who may not have demonstrated any other skill than that of inheriting affluent parents. They argue that this seriously distorts notions of equality of opportunity and is detrimental to widely shared notions of fair play.

A second line of debate concerns parental versus societal rights regarding the institution of inheritance. Opponents of the tax note that parents can pass resources to their children in a variety of ways: by investing in their education, providing social contacts and networks, bringing them into a family business, giving gifts of up to $10,000 per year, etc. They question why transfers at death should be treated differently from these other transfers. They also note that inheritances play only a small role in generating overall inequality.

Supporters of the estate tax look at the same set of transfers already being made and say "enough is enough." Irwin Stelzer, for example, notes that high estate taxes do not stop parents from passing on huge amounts of human capital, family reputation and connections, a common set of values, etc. He questions whether, given all of these transfers, the net social gains to having large amounts of financial resources passed on through probate exceed the costs, and he concludes that high estate taxes do not seriously impinge on parents' ability to provide for their offspring. In fact, the taxes create good incentives for younger people to work hard, and they help impress societal notions of fair play in the recipient generation.

Stelzer also notes that putting limits on the use of personal property is a natural role for society to play. Others have argued that inheritance is a civic right – not a natural right, so government has the duty, to regulate such activity.

These fairness issues hinge to a significant extent on value judgments, fairness being always and everywhere "in the eye of the beholder." As a result, it is quite difficult to resolve these issues analytically, and even more difficult to do so in a political arena.

8. Administrative and avoidance costs. It is often alleged that the estate tax is inefficient because avoidance and compliance costs are so high, and the tax is so easy to avoid. A Brookings Institution study from the 1970s referred to the tax as "voluntary" because of the large number of ways it could be avoided. Although tax reforms over the last two decades have tightened up a number of the most egregious features, aggressive sheltering (bordering on the abusive) remains a serious issue for the estate tax.

One issue is how high the costs really are. The widely cited claim that the costs of complying with estate tax laws are roughly the

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same magnitude as the revenue raised is a back-of-the-envelope calculation, at best. It is based on valuing the time of those American Bar Association members who report probate and estate law as their area of concentration. Even this methodology, inexact to be sure, yielded costs that came to just 15 percent of revenues; the 100 percent number from the same study has no quantitative basis.

So the oft-cited number is a hunch and no more – and is also more than a decade out of date. More recent estimates based on consultations with tax professionals about their average charges for estate tax planning produce a total cost of collection equal to only 7 percent of revenues. Thus, the available range of estimates of compliance costs relative to revenues is huge. We are inclined to believe that the truth lies much closer to the 7 percent figure. Moreover, an unknown fraction of this may be for estate planning, inter alia about intergenerational succession of the business, that is unrelated to taxation and thus would likely be incurred regardless of whether there was an estate tax.

In addition, if there are high compliance costs, it is not clear whether the tax should be cut back or be bolstered by broadening the base – eliminating loopholes – and reducing tax rates.

9. The non-profit sector. Supporters note that the deduction in the estate tax for charitable contributions generates a significant increase in contributions to the non-profit sector, especially among the wealthiest households. In 1997, of the 329 taxable estates with gross assets in excess of $20 million, 182 made charitable contributions and those that did contributed an average of over $41 million. The presence of an estate tax may also encourage increased charitable contributions during life.

Opponents counter with two claims: first, that the effect of the estate tax deduction for charitable giving is not that large, especially relative to the overall funds raised by the private sector; second, that eliminating the estate tax would raise wealth among the wealthiest families, which would in itself increase charitable contributions. Note, however, that the second claim contradicts the argument that estate tax does not affect the concentration of wealth. The first claim is an example of the selective use of assertions about the behavioral impacts of taxation. Opponents of the estate tax argue that it significantly alters decisions about saving, but play down its impact on philanthropy.

10. Revenues. Finally, opponents argue that the estate tax raises very little cash, so

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abolishing it would make little difference to federal revenue. This assertion does not appear to be factually correct: in light of their huge unrealized capital gains in the stock market, elimination of the estate tax would cost over $50 billion annually a few years down the road. But even if it were right, it begs the relevant question; should taxes

Eliminating the estate tax could cost $50 billion annually a few years down the road.

should be cut in this way, some other way or not at all?

A more sophisticated version of the "little revenue" argument is that stated revenues may vastly overstate the net revenue effect of the estate tax because the tax avoidance schemes that reduce estate taxes also reduce income taxes. Thus, for example, Stanford economist Douglas Bernheim argued several years ago that the estate tax effectively raises no revenue. If this were the case, then the estate tax would be difficult to justify, as it would create distortions to behavior while not raising any net revenue. This assertion is, however, based on speculative calculations and has not been corroborated by subsequent investigation.

WHERE DO WE GO FROM HERE?

The most radical reform would be to abolish the tax. This, of course, removes the existing problems, but introduces a host of additional issues. It would eliminate what is by far the most progressive tax instrument in the federal tax arsenal – and at a moment when the distributions of income and wealth are unusually skewed. It could hurt non-profits. It would reduce federal revenues. It might not even raise savings, labor supply or growth, as its advocates hope, and it would create a gaping loophole with regard to capital gains in the income tax. Moreover, the case for abolition appears to be backed largely by loose rhetoric about the immorality of taxing at death and the supposed impact on a tiny component of those who would benefit.

Elimination or scaling back of the estate tax could be coupled with the extension of the capital gains tax to the gains accrued but unrealized at death. But this proposal would raise much less revenue than the estate tax, would raise it from a different set of people, and would still have many of the complexities of the estate tax. Moreover, it would impose a significant burden on small businesses and farms, one set of groups that reform is intended to relieve of tax burdens.

The bill passed in the House earlier this year tied elimination of the estate tax to another significant change in the taxation of capital gains, under which heirs would assume the decedent's basis for capital gains purposes – "carryover basis" – for transfers from estates valued in excess of $1.3 million. Linking the two changes is designed to address the concern that the appreciated value of some assets might escape both income and estate taxation with no estate tax and step-up basis. However, this would raise less revenue than taxing gains at death and would be substantially more complicated because records would have to be kept for an even longer period of time. A similar item was passed in the late 1970s but was repealed before it ever came into effect, partly because

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of anticipated implementation problems.

These implementation problems have not grown easier to solve in the past 20 years. Thus, it seems likely that what the House really passed was an abolition of the estate tax.

Other than tossing out the tax, the appropriate direction for more modest changes in the estate and gift taxes depend in large part on what the system is intended to accomplish. If the goal is to help family-owned business and farms, then the appropriate exemptions could be implemented. But if that is done, it may make more sense simply to raise the exempt amount for all purposes, because doing so only for selected forms of assets creates both horizontal equity problems and inefficient sheltering incentives.

If the goal is to chip away at an undue concentration of wealth, then the effective exemption could be raised substantially – since only the extremely wealthy are the target here – and the high tax rates maintained. This could greatly reduce the number of people that have to pay estate taxes and simplify the tax. But it would also reduce revenues.

If the goal is to improve equality of opportunity, then estate tax revenues could be earmarked for special education and training programs, or for the kind of means-tested asset accumulation subsidies supported by President Clinton, Vice President Al Gore and Governor George W. Bush.

Base-broadening – that is, loophole-closing – and rate reduction carried the day in the last comprehensive income tax reform in 1986, and could improve the equity, efficiency and simplicity of the estate tax as well. Treating different assets in a more similar fashion would reduce sheltering opportunities and thus make the tax simpler and fairer. For example, legislation could address unwarranted valuation discounts and abusive trust arrangements. Reducing rates would also reduce the incentive to shelter.

Finally, it might make sense to replace taxes on estates and gifts given with taxes on gifts and inheritances received – as is the practice in several U.S. states and many foreign countries. Under a progressive inheritance tax (but not under an estate tax), spreading a given bequest among more legatees reduces the total tax burden. Some argue that by encouraging the splitting of estates, a progressive inheritance tax is a more effective instrument for restraining the concentration of wealth. In addition, a unified tax system would tax all the sources or all the uses of income. Currently, the income tax burdens sources and the estate tax falls on a particular use of resources. In contrast, the income tax combined with a tax on inheritances and gifts received would cover all major sources of income over the lifetime.

The historical record shows that transfer taxes of one sort or another can play an important role in the tax system. And, although many of the arguments put forth against the current estate and gift tax system are specious, there is also a significant undercurrent of truth. Likewise, supporters of such taxes need to distinguish between the benefits of such taxes in principle, and the design problems that arise in practice.

A transfer tax system that couples effective marginal tax rates of up to 73 percent with substantial opportunities to shelter funds is asking for trouble. An income tax with similar features in the 1970s was swept out in favor of a broader-base, lower-rate system in the 1980s. In light of these considerations, a package of lower rates and a higher exemption level, combined with a thorough cleaning of the tax base and perhaps judicious earmarking of estate tax revenues, might well ensure the survival of an effective transfer tax system. M

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# of Crabs and Motor and the Benefits of Free Trade

By Greg Rushford

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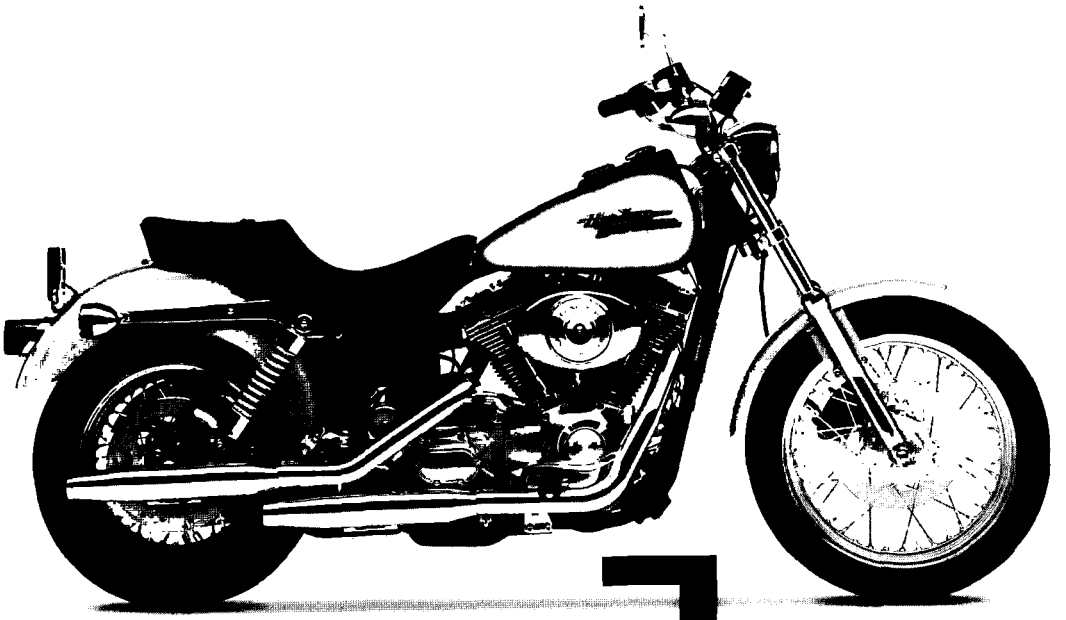

cycles

You don't need a Ph.D. in economics to understand why crabs and motorcycles are perfect metaphors for the benefits of free trade. I've explained it to eighth graders.

Consider the 250 men and women who work for Phillips Seafoods in Baltimore, where they make crab cakes, stuffed mushroom caps and other Maryland-style crab goodies destined for grocery stores and restaurants across America. The overfished Chesapeake Bay cannot even supply enough crabs for restaurants and groceries in the Baltimore-Washington area. So, how would Phillips' employees make those crab cakes if they were cut off from their supply of processed

LEFT: DAVIES+STARR INC./LIAISON INTERNATIONAL;
RIGHT: COURTESY OF HARLEY-DAVIDSON MOTOR COMPANY

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crabmeat that owner Steve Phillips imports from Southeast Asia?

Or what about the Americans who make Harley-Davidsons in York, Pa.? You can't drive those Hogs out of the showroom without carburetors and front suspensions, which come from Japan. So Harley's American workers do not want to be cut off from their foreign suppliers, right?

Well, try telling that to America's biker-in-chief (who's also been known to enjoy a crab cake or 10). President Clinton, no dummy, does understand that free trade is win-win economics. At least his Rhodes Scholar, Yale Law School side does. But when it comes to politics, the Slick Willie side calls the shots.

Clinton has made the calculated political judgement that the American people are not smart enough to understand why open markets are in their interest. Although Clinton will leave a free-trade legacy – the North American Free Trade Agreement and China's accession to the World Trade Organization – his administration's unwillingness to explain trade to the public in honest terms has tarnished that legacy.

To sell freer trade, the president and his top trade officials believe you must use the language of protectionism – mercantilism, to use that fine old 16th-century word. You must say that exports are good, but imports are, as Secretary of Commerce William Daley puts it, "problematic." And you must ritually bash foreigners, especially the Japanese, for unfair trade practices.

There is a President's Export Council, but in Washington it would be politically incorrect to create a federal body to praise cheap, high-quality imports. No wonder the American public is confused.

Clinton has made the calculated political judgement that the American people are not smart enough to understand why open markets are in their interest.

But forget high policy for the moment. Nitty-gritty stuff like motorcycles and crabs illustrates nicely what has been going wrong in Washington in recent years. Last November, the President traveled to York, where he proclaimed National Trade Education Day. That was the culmination of a 20-city public relations campaign run by Commerce Secretary Daley that was supposed to explain to ordinary Americans why trade – at least the export side of the equation – is good for them.

In York, Clinton's idea was to mark his administration's free trade legacy by building momentum for the World Trade Organization's ministerial meetings in Seattle three weeks later. Obviously delighted with a gift of a leather Harley jacket, Clinton spoke to an enthusiastic audience of some 2,000, which went wild to the tune of Steppenwolf's *Born to Be Wild.*

The President proudly noted that the Pennsylvania-made Harleys are now exported

GREG RUSHFORD is the publisher of Washington-based *The Rushford Report*, a newsletter on international trade (Rushrpt@aol.com).

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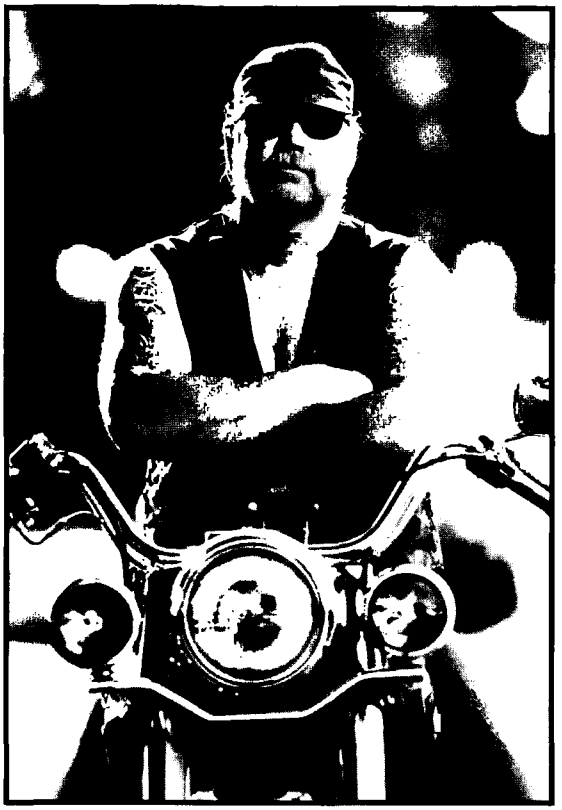

TONY ARUZZA/CORBIS

all over the world, even though the company had been underwater two decades earlier. "Several years ago, you were subject to unfair competition in the American market, and it took some action to get that straightened out," Clinton told the crowd, referring to Japanese motorcycle manufacturers' past successes against Harley.

Clinton deliberately passed up a chance to use the Harley example in a more honest way to explain the benefits of free trade. He could have just hopped on a Hog and asked, "How far would I get without that Japanese front suspension and carburetor?" The President could have explained that Harley-Davidson keeps its plant in York by buying components wherever it can find the highest quality for the best price.*

Instead, the leader of the free world used the opportunity to score some pandering points with the snide reference to Japan. Clinton surely knew that his Japan-bashing was inaccurate. After all, Clinton's two top officials at the Office of the United States Trade Representative – Charlene Barshefsky and her deputy, Susan Esserman – were Harley's lawyers when the company was going toe-to-toe with Japanese bikemakers.

This tale is worth the digression. In 1978, Barshefsky was a young associate at the Washington law firm of Steptoe & Johnson, which represented Harley-Davidson. Barshefsky worked on a complaint that accused Japanese motorcycle manufacturers of unfairly dumping in American markets. She lost the case. Struggling Harley was faced with tough Japanese competition – tough, but entirely fair. The American motorcycle maker was in trouble in part because of its own management weaknesses, and in part because the American economy was wheezing and Americans were not inclined to spend their extra pennies on bikes.

In 1983, Harley-Davidson's lawyers – now joined by Steptoe & Johnson's Susan Esserman – turned to another United States trade law, Section 201 of the Trade Act of 1974. Section 201 has nothing to do with unfair competition. The statute simply permits the President, upon the recommendation of the Congressionally confirmed International Trade Commission, to impose temporary quotas and tariffs to help American firms facing serious injury from rising imports. The idea is to give the domestic manufacturer a chance to regroup, on the premise that time is all the firm needs to get back on its feet.

At Harley's behest, President Reagan slapped a 45 percent tariff on heavy Japanese motorcycles (1,000 cubic centimeters and above), which lasted four years. Today, as Clinton noted in York, the firm competes suc-

**Of course, at that moment in his presidency, Clinton probably didn't want to display his fun side. Alas, the presidential restraint did not deter Jay Leno from telling his late-night television audience that that wouldn't have been the first Hog that Clinton had ridden.*

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cessfully around the world.

Harley's happy experience with Section 201 is often cited as the textbook example of how a little trade protection can sometimes work. Actually, it's a bit more complicated than that. As Dartmouth economist Douglas Irwin recalls, Harley's main competitors in producing heavy bikes were United States subsidiaries of Honda and Kawasaki. As far as United States trade law was concerned, Kawasaki's Nebraska plant and Honda's operation in Marysville, Ohio were American companies, just like that American icon, Harley-Davidson. So, having been proclaimed part of the United States motorcycle industry, Honda and Kawasaki got to enjoy the same tariff protection as did Harley against competitors from Japan. And like Harley, the Japanese United States subsidiaries came out of 201 stronger than before. Whatever the source of Harley's recovery – we would guess that it was a tacit decision by Kawasaki and Honda to ease off the competition – it wasn't Section 201.

Today, Honda of America – which set up motorcycle operations in Marysville in 1979 – still employs more than 750 Americans to make cycles, along with 13,000 workers to make automobiles. Indeed, Honda is Ohio's largest employer.

Of course, to a Democrat like President Clinton, Marysville is not a suitable place to explain the ironies of trade law. Like Vice President Al Gore – who says he likes cars made in America "by the UAW" – Clinton isn't about to look for support from Honda workers, who are famously nonunion. The last presidential candidate to stop by Marysville was Bob Dole.

This may sound like ancient history, but it isn't. Remember those 250 Baltimore employees of Phillips Seafoods who make crab cakes and such from meat imported from Asia? The Phillips' employees have reason to hope that when it comes to them, Clinton will display a better understanding of how Section 201 works than he did in crowing about the Harley case. In March, the jobs of those Americans – along with those of some 3,000 more Americans who work for Phillips' restaurants and national sales operations – were put at risk when a coalition of domestic crab pickers asked Clinton to invoke Section 201 to roll back the crabmeat imports.

An advertising campaign is going to explain to patriotic Americans why foreign crabmeat is un-American. Next: be on the alert for foreign shrimp.

The Blue Crab Coalition is composed of crabmeat producers in the Chesapeake Bay area, down the Atlantic Coast to the Carolinas, and across the Gulf of Mexico to Texas. These are the people who buy local crabs, separate the meat, and sell most of it fresh in their regions.

That, by the way, is the first problem. Since fresh crabmeat has a shelf life of about a week, it can hardly supply national markets. Phillips' processed Asian crabmeat, by contrast, can last 18 months.

A second problem is that because of overfishing, there aren't enough domestic crabs to supply national markets anyway. And with low supply comes high prices: I've seen fresh jumbo lump crabmeat offered for as much as

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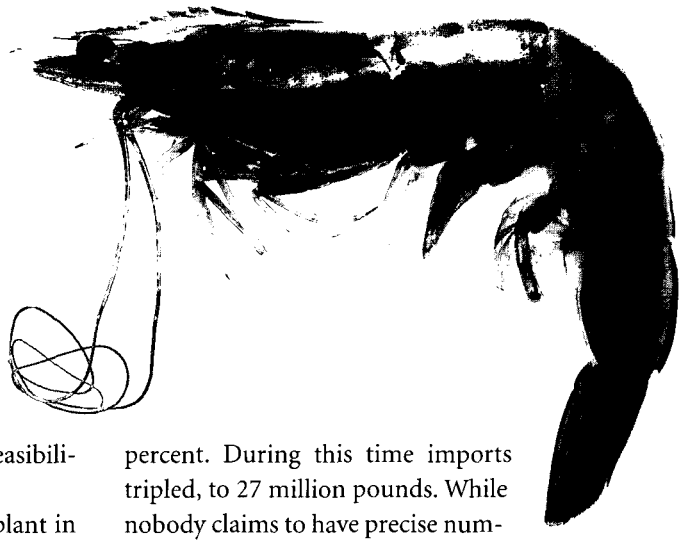

$35 a pound in the Washington-Baltimore metropolitan area.

This is where Steve Phillips comes in. When he started having difficulties finding enough local crabs for his family's restaurant chain in the late 1980's, Phillips headed for Asia. "Nobody was processing crabmeat in the Philippines," Phillips said. "So I got a pump boat, set out some crab pots at different depths, and did my own feasibility study."

Phillips set up his first Philippine plant in 1990, and soon expanded to Indonesia, then to Thailand. He now employs 13,000 Asians to process crabmeat for Americans. Recently, Phillips has also begun exporting to England.

Cut off Phillips' Asian supply, and other Americans would quickly feel the pinch. Jim Dixon, vice president of Dixon Fisheries in Peoria, Ill., says that the crab products he buys from Phillips have become a major part of his business. In the past five years, his use of Phillips' crabmeat has shot up from 600 pounds a month to 4,500. And though he has tried, Dixon has been unable to serve the Peoria-area market with crabmeat from domestic processors. Thus, without the Asian crabmeat, Dixon says, "a great part of this business would disappear."

Disappear, however, is what the United States members of the Blue Crab Coalition say will happen to them without a little help from Uncle Sam. "We can't compete against $4-a-day Asian wages," says Jimmy Johnson, the crab association's past president. Johnson adds that he has the numbers to back him up. According to the coalition's Section 201 petition, which is now before the International Trade Commission, the domestic processors' share of United States markets was 67 percent in 1994, but has since dropped to about 27 percent. During this time imports tripled, to 27 million pounds. While nobody claims to have precise numbers for this small, family-owned industry, the coalition says that employment has dropped by a quarter, to about 2,900.

When I spoke to him before the Section 201 petition was filed, Johnson said his association, which had formerly numbered perhaps 50 processors, was "now down to about 12." He lamented that domestic crab pickers don't have enough money to expand their operations, and can't generate enough capital to modernize.

That is a problem, but what is the solution? Barriers to foreign crabmeat would help the members of the Blue Crab Coalition to hang on to their jobs. But what about the jobs of Americans who work for Steve Phillips and Jim Dixon? And what happens after the temporary barriers expire? "Quotas could be renewed," offered Jimmy Johnson.

If ever more quotas sounds like a flimsy plan, wait: it gets flimsier. The Blue Crab Coalition's 201 petition says "the strategy for recovery will include a consumer education campaign to promote a separate identity for the United States product...."

Neat: an advertising campaign is going to explain to patriotic Americans why foreign crabmeat is un-American. Who is going to believe that a stuffed mushroom cap made

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from crabmeat from Thailand is going to taste worse than a stuffed mushroom cap made from an American crab? Next, be on the alert for foreign shrimp.

That's not a joke. Louisiana shrimp people (who don't like foreign competitors much, either) are watching the crab case closely. Another reason not to laugh away the Section 201 crabmeat case is that the decisions will be made in Washington, where sensible economics has a habit of giving way to politics. Stay tuned for the International Trade Commission's decision on crabs, due this summer.

Section 201 largely fell into disuse after the 1983 Harley-Davidson case. In fact, the last time a president used the statute was 1986, when President Reagan slapped tariffs on wood shingles from Canada. But Bill Clinton has rediscovered the statute's potential for making lobbyists happy.

Just before he left office in January 1993, President Bush refused to take a Trade Commission recommendation for Section 201 relief for extruded rubber thread – the elastic stuff from Malaysia, Indonesia and Thailand that holds your underwear up. But since 1996, the International Trade Commission has had much better luck.

That year, the tiny United States industry (employing some 500 people) that makes whisk brooms asked for protection from its Mexican competition. Whisk brooms have been around since Ben Franklin's day. They are made from broomcorn, which has a finer leaf than the corn you see in Iowa. And in the wake of the successful whisk broom petition, Clinton was asked to slap on various tariffs and quotas: (1) to help out the United States wheat lobby, which had a gripe about wheat gluten from Europe; (2) to protect American lamb meat processors, who say they want to get back on their feet to better compete with Australia and New Zealand; (3) to give the American makers of wire rod some protection, mainly against Japan and Korea; and (4) to curtail imports of pipes that are used for oil and gas pipelines, again from Japan and Korea.

In every case, Clinton approved protection. Clinton, of course, is not the first United States president to talk the free-market talk without walking the straight-and-narrow free-market walk. And despite the lapses, many will argue that Clinton has earned a legacy as a strong free-trade advocate.

But the lapses have been costly. The ministerial meeting of the World Trade Organization last December collapsed largely because of Clinton Administration hypocrisy. Japan, Europe and many of the organization's poorer members were deeply angered when the Americans insisted they take the politically difficult steps to open their markets – especially agricultural markets – and then refused to discuss United States sugar and textile quotas that distort global markets.

Meanwhile, public opinion is left rudderless on trade. A recent poll conducted by the nonpartisan Association of Women in International Trade found that 62 percent of Americans admitted that they were "not at all" or "only a little" knowledgeable about current trade issues, even though 57 percent said they were inclined to support free trade.

You would think that Bill Clinton – an articulate president who knows the subject – could have found a way to explain to ordinary people why trade benefits their daily lives. Clinton could even have pointed to the United States makers of whisk brooms, the same folks who asked for higher tariffs on brooms from Mexico.

Guess where those Americans get the special corn leaves that they need to make their whisk brooms? Mexico. M

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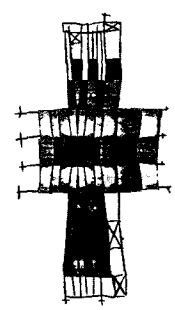
The Fourth Great Awakening

ILLUSTRATIONS BY SIBYLLE SCHWARZ

You've probably heard of Robert Fogel, one of just two economic historians to win a Nobel in economic science.* And you may have heard that while he is one of the nicest people alive, he is also an iconoclast who seems happiest when he is stepping on historians' toes. It was Fogel who questioned the importance of railroads in the Westward movement of the American economy. And it was Fogel who argued that antebellum slave owners were more or less rational in their treatment of human beings as another form of machinery. ¶ What you may not have heard, however, is that Fogel is a renaissance scholar, that rare intellectual whose work integrates research from many specialties. For much of the last few decades, he has been investigating the impact of public health on history. And in *The Fourth Great Awakening*© he has embarked on his most ambitious project yet: an investigation of the role of religion and ethics in economic development. ¶ The excerpt published here is culled from several chapters of his new book. And while it doesn't do justice to Fogel's argument that we are in the midst of a religious revival that is reshaping the economic policy agenda, it does give a sense of his breadth as a historian and social thinker.



BY ROBERT FOGEL

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**The other is Douglass North, whose pensées appeared in the last issue of* The Milken Institute Review.

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Upsurges in religious enthusiasm in America have tended to run in cycles lasting about 100 years. Each cycle consists of three phases, each about a generation long, beginning with a phase of religious revival that intensifies religious beliefs and ushers in new or reinvigorated ethics and theological principles. The phase of religious revival is followed by a phase in which the new ethics precipitates powerful political programs and movements. Each cycle ends with a phase in which the ethics and politics fostered by the religious revival are challenged and the political coalition promoted by that revival goes into decline.

Those who directly identify with the new principles of a religious revival are usually a minority, but what they lack in numbers they make up in enthusiasm and energy derived from a sense of the righteousness of their cause. They have been able to extend their political influence far beyond their numbers by building coalitions on single issues, as in the movements against slavery and for prohibition.

Historians of religion refer to such periods of religious revival as Great Awakenings. They generally agree that the United States has experienced three Great Awakenings. I contend that the United States is currently experiencing its fourth, which began about 1960.

The new religious revival is fueled by a revulsion with what believers see as the corruption of contemporary society. Believers in the new religious revival are against sexual debauchery, against indulgence in alcohol, tobacco, gambling or drugs, against gluttony, and against all other forms of self-indulgence that titillate the senses and destroy the soul. The leaders of the revival advocate piety and an ethic that extols individual responsibility, hard work, a simple life, and dedication to the family. They emphasize that, in order to resist the corruptions promoted by Satan and abetted by many people in business and political life, individuals must dedicate themselves to God by embracing an unrelenting struggle for self-purification. They call on their adherents to strive for a mystical experience that will cleanse them of sin and lead to spiritual rebirth.

To understand the meaning of the Fourth Great Awakening, it is necessary to understand the effect of the three previous religious-political cycles on social and economic policy. America was, at its beginning, a deeply religious society. Until 1790, about 80 percent of Americans (90 percent of the free population) were of British descent and were attached primarily to the dissenting British churches: Congregationalists, Presbyterians, Baptists, Quakers and Methodists. Another 5 percent were pietistic Germans or Scandinavians whose religious creeds were similar to those of the dissenting British churches. The New England strain of these denominations was particularly strong in America because of favorable demographic conditions that produced both unusually high birth rates and

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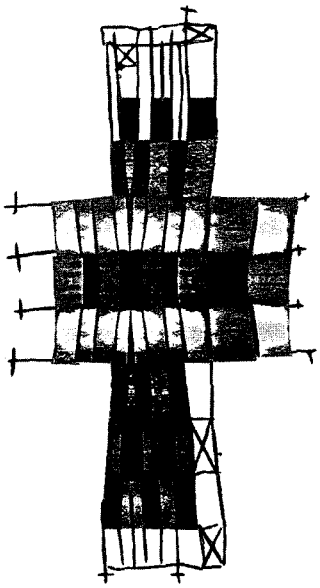
unusually low death rates. Thus, while Puritans made up just 5 percent of all the Europeans who migrated into the United States before 1820, descendants of the Puritans represented about 80 percent of the northern and about 20 percent of the southern populations in 1820.

THE FIRST GREAT AWAKENING

Although the Puritan founders of New England were deeply dedicated to their religious principles, their children and grandchildren were more equivocal. Religious enthusiasm waned until the early 18th century, when a new surge of religious feeling became evident. One of the most inspirational figures of what came to be known as the First Great Awakening was George Whitefield, an itinerant minister from England who was influenced by both Methodism and Calvinism. From 1738 to 1740, Whitefield evangelized in both northern and southern colonies with an explosive emotional power. Whitefield, who returned to America many times, inspired other ministers and lay itinerants to take up the task of extending the revival to every corner of the British colonies. Jonathan Edwards, a Congregational minister to a venerable church in Massachusetts, was the leader of the revival in New England and the most influential theologian of the era. Edwards held out hope that unregenerate sinners might yet be saved through conversion.



The main theological features of the First Great Awakening were the justification of emotional revival meetings, with the emphasis on conversion as the central objective of the revivals, the emergence of the ethic of benevolence as an aspect of conversion, and the modification of the Calvinist doctrine of predestination, which held that only those designated before birth by God would be saved. Advocates of the new theology often undermined the authority of church leaders by calling on people to trust their own experience. Revivalist leaders accused orthodox leaders of corrupting the church by their pursuit of power and luxury. Although the challenge to Calvinist doctrine may be appropriately described as latent, it laid the basis for the frontal assault on orthodoxy that emerged during the Second Great Awakening.

The First Great Awakening's political ascendancy ran from 1760 through 1790. It was marked by attacks on British moral and political corruption and by charges that this corruption was being foisted on the American colonies, where it threatened the attainment of spiritual and political virtue. Considering that the new-light religion provided much of the popular ideological foundation for the Revolution, it is ironic that many of the political leaders of the Revolution were deists – individuals who believed that, although God had set the world into motion, he did not play an active role in human affairs. Steeped in the rationalism of the Enlightenment, and harboring suspicions of the established churches, the leaders of the Revolution tended to view all political issues through the prism of natural rights rather than divine revelation.

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The Revolution thus served to weaken, rather than enhance, religion. Several of the denominations – the Friends, the Anglicans and the Methodists – were in disrepute for failing to back the Revolution. Others suffered from the spread of rationalism and from the migration of many members to the frontier, both of which led to a decline in church attendance. Moreover, the overriding urgency of military and political issues sapped the vitality of religion. During the last phase of the First Great Awakening, which extended from 1790 to 1820, the revolutionary coalition of evangelicals, deists, farmers, artisans and slaveholders broke apart along ideological and partisan lines, and the influence of the churches was at its lowest point in American history.

THE SECOND GREAT AWAKENING

The Second Great Awakening began about 1800, and its revival phase lasted until 1840. During this time, the camp meeting, a vehicle for mass conversion in rural areas, emerged. In the North, the doctrine of predestination was further weakened, and a new theology, reflecting Methodist influence, arose – one holding that anyone was capable of achieving saving grace through a determined struggle against sin. Those who sought a state of grace were told to guide themselves by the principles of disinterested benevolence. They were assured that, if they achieved grace, they would be healthy and prosperous. Those who were condemned would be visited by economic and other catastrophes. Lurking in this view was the belief that poverty was the wages of sin, a doctrine that gained in strength after the Civil War.

Leaders of the Second Great Awakening also preached that the American mission was to build God's kingdom on earth. Belief in the imminence of the millennium promoted a zealous quest not only for personal but also for social perfection. An array of reform movements sought to make America a fit place for the Second Coming of Christ. These included the temperance movement, which at

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first sought to convince individuals to cease drinking alcoholic beverages voluntarily; the abolitionist movement, which initially hoped to persuade slave owners to free their slaves voluntarily; and the nativist movement, which aimed either to curtail the large number of Catholics entering the country or to convert them to Protestantism.

During the political phase of the Second Great Awakening (1840–70), the temperance movement succeeded in getting many state and local governments to regulate the sale of alcohol. The high point of this campaign was reached between 1846 and 1855, when 13 northern states prohibited the sale of all alcoholic drinks. The Second Great Awakening also focused on urban reforms like getting rid of corrupt city governments and protecting children through compulsory education and limits on child labor.

Militant abolitionists like William Lloyd Garrison initially focused their campaign not on the state but on the denominations. They wanted their churches to condemn slavery as an extraordinary sin that created an insurmountable barrier to personal and national salvation. Although that creed gradually gained adherents, it remained a minority doctrine even within the northern churches.

A faction of these radicals decided to go over the heads of church leaders by shifting the struggle to the political arena. That decision diluted the benevolent content of the antislavery appeal, but greatly broadened the antislavery coalition and eventually led to the formation of the Republican Party.

Republicans continued to appeal to the benevolence of voters, especially in New England and in the Yankee diaspora (the area west of the Hudson River and north of the Mason-Dixon line to which New Englanders and their descendants migrated). However, they increasingly urged the northern electorate to vote for them not because it was their Christian duty to free the slaves, but in order to prevent slaveholders from seizing land in the territories that rightly belonged to northern whites; to prevent slaveholders from reducing the wages of northern workers by inundating labor markets with slaves; and to prevent the slave power, in an alleged alliance with the papal power and operating through the Democratic Party, from seizing control of the government.

Steeped in the rationalism of the Enlightenment, the leaders of the Revolution tended to view all political issues through the prism of natural rights rather than divine revelation.

The fate of slavery was decided by the Civil War. However, the deep hostility of southern whites and the ambivalent support of northern whites compromised the struggle for the civil equality of ex-slaves. By the end of the 1880s, most of the abolitionist leaders were dead or had retired, and their places in the northern evangelical movement were taken by men and women preoccupied with a different set of issues, especially Darwinism and the growing urban crisis.

THE THIRD GREAT AWAKENING

The Third Great Awakening began about

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1890, and the religious-revival phase extended to 1930. It was marked by a major theological split among the principal evangelical churches, with the winning faction rejecting the proposition that poverty was the wages of sin. This split was, to a large extent, precipitated by the urban crisis. Evangelicals were divided on how to reform the cities, which were growing at alarming rates and were viewed as centers of corruption, crime, drunkenness, prostitution and graft that threatened to infect the entire society.

Darwinism was another issue that promoted splits. Darwin's theories did not just challenge the biblical account of creation. By describing nature as amoral and purposeless, they also challenged the millennial goal, the building of God's kingdom on earth.

Increasing labor conflict was a third problem that faced the reformers of the Third Great Awakening. In an agrarian world of property owners who abhorred any infringement on property rights, it had been relatively easy to make strikes illegal and to use troops to suppress them. But in the new urban world, the great majority of the laboring population owned relatively little, and was thought to be open to anarchistic and syndicalist notions imported from Europe. In such a world, old methods of containing labor strife seemed inadequate.

Debate over these issues produced two camps. Conservatives wanted to stand fast on creedal issues and continued to emphasize the centrality of personal conversion and morality. The most uncompromising of the old lights came to be called *fundamentalists* because of their insistence on the inerrancy of the Bible. Some, like William Jennings Bryan, the Democratic candidate for the presidency in 1896, 1900 and 1908, supported the whole panoply of progressive labor reforms, but the majority hewed close to the urban reform program of the Second Great Awakening. The fundamentalists were initially strong in all regions of the country, in the cities as well as the countryside.

The winning camp of the Third Great Awakening is called *modernist* or *liberal.* Modernists applied scientific principles to the Bible, on the assumption that it was a historical document written by men who were trying to understand God's will within the context of their own times. Modernists also believed that evolutionary theory was consistent with biblical thought because the world was evolving, not only toward human beings as the highest form of life, but also toward ever more perfect human beings. In this view, the laws of nature were God's laws, and scientists would discover them. As theologians were needed to interpret the Bible, scientists were needed to interpret nature.

The millennialist dream of the Second Great Awakening thus became transformed by the modernists. Disciples of the Second Great Awakening had the wrong theory of how the millennium would arrive, the modernists believed. The new theory emphasized, instead of the Second Coming, a new, more secular optimism about perfecting American society. In the place of divine revelation, there now stood the revelations of science. Since most of the problems were not physical or biological but social, a new breed of social scientists was required who understood the problems of the cities and who knew how to alleviate the social crises of the age.

A radical wing of the modernist camp came to be called the *Social Gospel* movement. Its leading figures argued that, if America were to revitalize itself, it would have to change not only its theory of man's relationship to God, but also its ethics. It would have to make poverty not a personal failure, but a failure of society. And evil would have to be

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seen not as a personal sin but as a sin of society. According to these radicals, it was the obligation of the state to improve the economic condition of the poor by favoring labor and redistributing income – reforms necessary to put an end to urban corruption.

During most of the revival phase, conservatives were in control of the church hierarchies, and the reforms that they promoted were those left over from the Second Great Awakening – the reform of graft-ridden city governments, the protection of children through compulsory education and limits on child labor, the prohibition of alcohol, the extension of the franchise to women. It was not until well into the New Deal that the political reforms of the Third Great Awakening, including the establishment of the welfare state, moved to the top of the legislative agenda. Indeed, into the 1920s, theological conservatives remained on the offensive, seeking to limit the influence of the modernists and Social Gospelers within denominational circles.

During the 19th century and into the early 20th century, colleges and universities were religious institutions and focal points for revivals. Their presidents were usually ordained ministers who taught required courses in moral philosophy or natural theology. However, during the Third Great Awakening, modernist and Social Gospel theories were widely embraced by university teachers, who taught them to their students. Moreover, for reasons that had more to do with technology than with ideology, the student bodies of the colleges and universities began to expand at a remarkable rate. By World War I, universities were producing far more secular than sacred writers. Journalists, essayists, historians, social scientists, novelists and dramatists who embraced modernist ideology were turned out by the tens of thousands. They became entrenched in the new mass media – low-cost daily newspapers, glossy magazines, inexpensive books, popular theater, vaudeville and movies – which they used to attack conservative religion.

These attacks were so successful that they drove the fundamentalists out of their denominational offices and into sanctuaries sheltered from public criticism. The victory of the modernists and Social Gospelers laid the basis for the welfare state, providing both the ideological foundation and the political drive for the labor reforms of the 1930s, 1940s and 1950s, for the civil rights reforms of the 1950s and 1960s, and for the new feminism of the late 1960s and early 1970s.

THE FOURTH GREAT AWAKENING

The phase of religious intensification in the Fourth Great Awakening began in the late 1950s and early 1960s, when church membership in all denominations began to grow. However, from the mid-1960s on, only the enthusiastic religions grew rapidly, cutting deeply into the normal membership of the mainline churches while drawing many unchurched persons into the fold. Over the past three decades, membership in the principal mainline Protestant churches of America has declined by 25 percent, while membership in enthusiastic churches (such as Pentecostal, Adventist, and neo-fundamentalist) has nearly doubled. In the case of certain enthusiastic denominations, such as the Mormons, membership has quadrupled.

By the end of the 1980s, enthusiastic religion had about 60 million adherents, representing about one-third of the electorate. Although often identified with the rapidly growing fundamentalist denominations, the movement is far wider. It includes about 20 million people in the churches of the mainline Protestant denominations, 6 million

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Catholics who have reported a born-again experience, and nearly 5 million Mormons. Some mainline churches have responded to the demand for a more passionate religion by embracing Pentecostalism; even the Roman Catholic Church has launched its own charismatic movement.

Single-issue movements began to emerge about halfway through the religious phase: the right-to-life movement came during the mid-1970s, tax revolts exploded in the late 1970s, and the movement to reform the media followed early in the 1980s. These developments are comparable to the temperance, nativist and abolitionist movements of the 1830s and early 1840s, which, despite considerable success, were viewed as zealous minority efforts far from the mainstream of political life.

In 1979, the Moral Majority emerged with a bid to become the vehicle through which believers in enthusiastic religion could unite on a national program that included opposition to abortion, support of prayer in the schools and the elimination of pornography. Although it had significant success in shifting intensely religious voters from the Democratic to the Republican column during the 1984 elections, the Moral Majority was, like the branch of the abolitionist movement of the 1840s led by William Lloyd Garrison, too rigid theologically and too focused on one issue. Tarred by the televangelist scandals of the mid-1980s, the Moral Majority collapsed in 1989, its place taken in 1990 by a broader movement called the Christian Coalition.

The Christian Coalition differs from the Moral Majority in that it is more clearly focused on politics, is more willing to compromise on key issues in the interest of extending the coalition and has better connections among enthusiastic religionists in the mainline churches. As an example of its willingness to appeal to a broader base, the Christian Coalition has placed the traditional family above abortion as a coalition issue. The Christian Coalition has also reached out to economic conservatives by integrating tax reduction and smaller government into its social program, linking these issues to principles regarding individual responsibility. This move to a less dogmatic, more issue-oriented basis for institutional change recalls the compromises made by such politically skillful abolitionists as Salmon P. Chase, senator from and later governor of Ohio, when he joined with former adversaries in the 1840s and 1850s in creating the Free Soil Party and then the Republican Party on a minimalist anti-slavery program.

An array of reform movements sought to make America a fit place for the Second Coming of Christ.

The persistence of the forces of the Fourth Great Awakening through the political ups and downs of the 1980s and 1990s, the increased flexibility of its tactics, the broadening of its coalition to include more members of mainline churches, Jews and blacks, indicate that the effect of the Fourth Great Awakening will remain widespread. In years to come, it will be impossible to understand political and ethical trends or economic developments without understanding the movement centered on enthusiastic religions.

This view was confirmed by the outcome

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of the 1996 and 1998 elections. Not only did the Republicans maintain control of both houses of Congress, but President Clinton and Vice President Gore also changed their rhetoric and their policies – think of welfare reform – to increase their appeal to born-again Christians. Clinton's effort to reach out to this part of the electorate calls attention to the complexity of the political realignments spawned by the religion-inspired reform movements of previous Great Awakenings. For example, although the Republican Party was the principal vehicle for promoting the reform agenda of the Third Great Awakening, many progressive evangelicals shifted their allegiance to the Democratic Party when Woodrow Wilson combined evangelical appeals with a vigorous pursuit of policies previously identified with Republicans.

This shift of supporters of the Third Great Awakening from the Republicans was too modest to keep the Democrats in power during the 1920s, but the shift continued, culminating in the 1930s with the presidency of a Democrat, Franklin D. Roosevelt. The lesson is that coalitions spawned by religious movements are more ideological than partisan.

The resistance of the majority of Democrats in Congress to Clinton's strategy of courting white evangelicals suggests that ideological considerations within the Democratic Party are stronger than purely partisan considerations. Consequently, the Republican Party is likely to continue as the principal vehicle for the political reforms sought by leaders of the Fourth Great Awakening.

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Nevertheless, the flexibility shown by Clinton, Gore and a significant minority of the Democrats calls attention to the fact that there are many issues stemming from the ethics of the Fourth Great Awakening that are also embraced in the ethics of the Third Great Awakening.

For example, "sexual harassment" may have originated as a slogan of the feminist movement, but its content is Victorian, and setting limits on sexual aggression conforms with the wish to return to traditional family values. Other reforms that unite large parts of both ethical camps include promoting education, curtailing pornography and violence in the media, abolishing state-sponsored gambling, and suppressing illegal drugs.

Technological Change, Cultural Transformation and Political Crises

The ethical crises, religious upsurge and social demands that heralded the opening decades of the Fourth Great Awakening were precipitated by technological breakthroughs that destabilized prevailing culture. Some of those unsettling advances included energy production (particularly nuclear energy), information retrieval, and communications. The unprecedented extension of control over human biology, particularly in reproductive technology and organ transplantation, also provoked widespread concern.

The new technology raised profound ethical and practical issues, including many that had never been considered previously, such as how to dispose of large quantities of radioactive waste. And some people became alarmed that humanity was heading toward disaster, led by corrupt or mindless scientists and business leaders.

This turn in perceptions was not immediately obvious to those of us who inhabited the world of science. In our classes, we still sought to find ways that would make the great technological and economic accomplishments of the Industrial Revolution meaningful to students. And so, on a day in the mid-1970s, David Landes, doyen of economic historians at Harvard University, lectured to more than 1,000 students in the highly popular introductory course in economics. "Look to the left of you and to the right of you," he said. "If it were not for the Industrial Revolution, two out of every three of you would not be alive." The point drove home one of the great benefits of modern economic growth: the enormous increase in life expectancy during the previous 200 years made possible by new economic and biomedical technologies.

The post-World War II enthusiasm for technological change was still close to its peak in the 1970s. Not only had the advanced technology of the United States made it possible to defeat the war machines of Germany, Italy and Japan, but the new technologies of the postwar era also touched off a period of such unprecedented economic growth that it obliterated fears that Europe and the United States would be plunged back into the destitution of the Great Depression.

Memories of the Depression made it hard for many Americans to have faith in the viability of free-enterprise systems. But, as the years of prosperity rolled on through the 1950s and the 1960s and into the 1970s, optimism replaced pessimism, and it was widely believed that we had entered a golden age. This was the age in which Herbert Hoover's failed promise – a chicken in every pot, a car in every garage – was finally realized. Most homes in the United States had electricity. Television was in nearly 90 percent of homes by the late 1950s.

By the mid-1970s, not only the rich but also virtually everyone in the middle and many at the lower end of the income distrib-

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ution owned a washing machine or had access to one. Numerous other new consumer products liberated women from the drudgery of household work and permitted millions of them to enter the labor force. Henry A. Wallace, vice president during Franklin D. Roosevelt's third term (1941–45), courted incredulity when he promised 60 million peacetime jobs. During the postwar boom, in fact, employment rushed toward the 100 million mark, a figure that was not surpassed until the 1970s.

In such heady circumstances, it was easy to herald technological change as a savior. To many economists, business leaders and politicians, technological change was transparently good and beneficial to virtually everyone. It was an incoming tide that raised all ships.

But disenchantment surfaced during the 1960s. As the former Axis powers and our European allies recovered from the devastation of World War II, they emerged as serious competitors in the United States market. With state-of-the-art technologies in newly reconstructed industries, and with labor costs that were a fraction of those in the United States, foreign competitors began to conquer markets that had seemed secure from outside competition.

Textiles and steel were among the first industries to be undermined. Many small and medium-sized apparel firms in the United States were forced out of business during the late 1950s and early 1960s, because the Japanese were delivering ready-made clothes that were less expensive than the cloth that American suppliers sold to domestic producers. Steel began to suffer from Japanese competition in the 1970s. German cars provided the most serious competition to Detroit during the 1960s, but, after the gasoline shortages of 1973, small Japanese cars flooded the American market.

Disillusionment with the virtues of technological change was symbolized by the publication of Rachel Carson's *Silent Spring* in 1962. *Silent Spring* poignantly described the devastation of robins by the pesticide DDT, overlooking the fact that its use lowered food cost and saved millions of human lives during the worldwide campaign to eradicate malaria.

Even science came under assault. The most dramatic symbol of the growing disenchantment was the rise of the movement against nuclear energy. During the 1960s and early 1970s, nuclear energy was so enthusiastically embraced as a new, clean, limitless source of energy that, by 1975, an eighth of all electricity in the United States was generated in nuclear plants. Nevertheless, the fear of nuclear war, the sense that this source of energy had been conceived in the sin of Hiroshima and Nagasaki, and the testimony of some scientists that nuclear energy posed enormous hazards to health produced a movement so powerful that it brought further construction of nuclear energy plants to a screeching halt.

Economic and social historians were not surprised by this turn of events. They knew that the history of technological change was replete with protest movements. Some were sparked by workers displaced by the new technologies, as in the case of British handloom weavers, who were devastated by the introduction of the power loom. That drama was repeated in traditional societies, such as India, when cheap British cloth penetrated their markets, undermining indigenous handicraft production.

In other cases, the protests were sparked by citizens alarmed by the threat to the prevailing culture posed by the new technologies. The railroads, for example, were fiercely and deeply resisted when they were first intro-

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duced. They were denounced not only as products of Satan and threats to civilization, but also as threats to health and life. Much the same was said of airplanes.

It has been argued that such crackpot movements of the past cannot be compared to the modern revolt against technology. Whereas the movement against, say, nuclear energy is based on weighty scientific evidence, the opposition to railroads and airplanes was based on prejudice and superstition. However, scientific arguments were as hefty a weapon in the opposition to railroads in the 1820s and 1830s as they have been in the opposition to nuclear energy in our time. Railroads, opponents claimed, were great dangers because of exploding locomotives and the innumerable fires that would be caused by the sparks of engines in normal operation. They feared that the noisy monsters would sicken cattle and poison cows' milk. The long-term biological danger to people who traveled at speeds of 30 miles per hour or more for sustained periods of time was thought to be even more threatening. Many of these dangers were far from theoretical: thousands were maimed or killed in rail accidents.

These arguments are similar to those advanced by opponents of nuclear energy, who stress the theoretical hazards of radiation associated with accidents at nuclear installations and with the disposal of nuclear waste. Many centuries will have to pass before the evidence needed to prove or disprove contentions that the danger to life posed by the use of nuclear power exceeds that posed by other forms of energy.

The Benefits and Costs of Modern Economic Growth

At the beginning of the period of modern economic growth, the principal nations of the world had approximately equal per capita incomes – all of which were very low by current standards. But large gaps developed between the average incomes of countries that once had been equally poor. By the 1850s, Britain, for example, enjoyed a real per capita income that was more than double the 1750 level. By 1960, British real per capita income stood at more than nine times the 1750 level. In contrast, the real per capita income of India and China in the 1960s were still stuck at levels close to those that had prevailed two centuries earlier. Even Japan was still a relatively poor country in the mid-1950s.

By describing nature as amoral and purposeless, Darwin's theories challenged the millennial goal, the building of God's kingdom on earth.

The first stage of economic growth in Britain, France and other early starters took place in agriculture. In Britain, the development of intensive methods of land utilization and of new varieties of traditional crops, along with the introduction of new crops used for fodder (such as peas and clover, which added nitrogen to the soil), also raised the productivity of agricultural workers more rapidly than the rate of growth of the population. Consequently, the average consumption of calories slowly increased, rising by 10 per-

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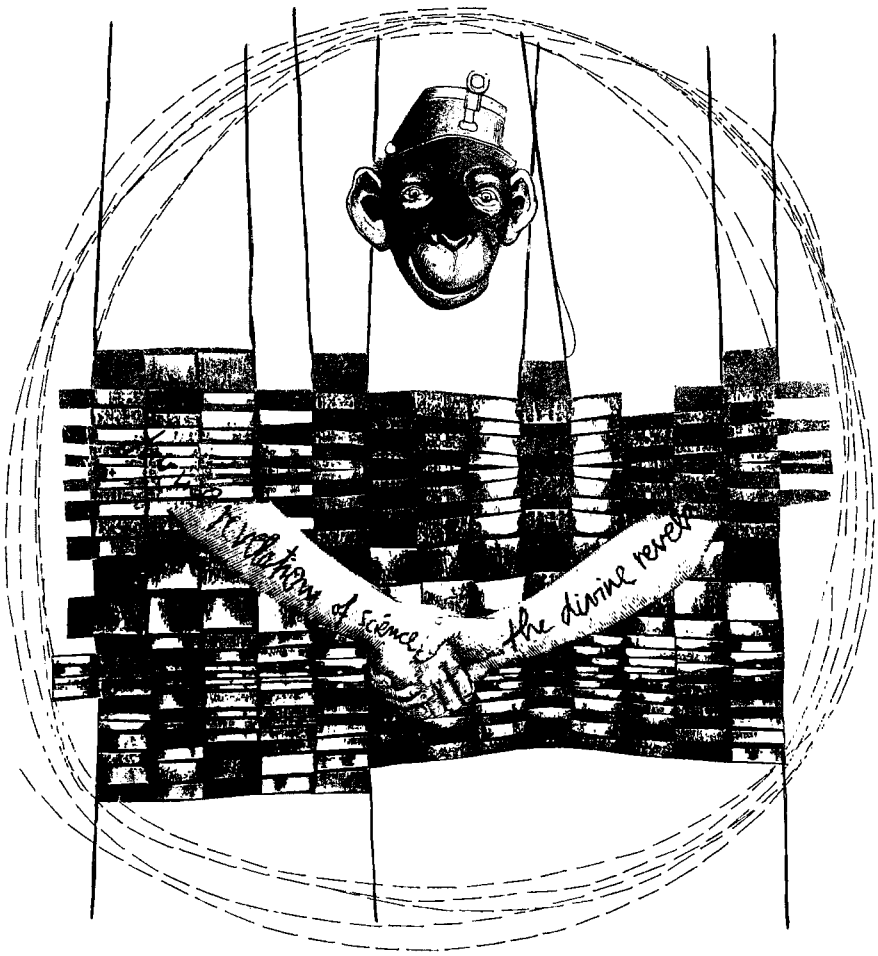

cent between 1700 and 1800, and by another 10 percent between 1800 and 1850.

This blessing had a downside. Because agricultural workers' output of food increased more rapidly than the population, the supply of food came to exceed the demand for it. Many agricultural workers therefore became redundant and were pushed off the land, a process that began in the 18th century and continued through the 20th century. Some of these displaced workers joined the ranks of the rural unemployed. Others moved into the cities in search of jobs in trade or manufacturing. While some found urban jobs, others became part of a pool of homeless workers that hovered between 10 and 20 percent of the potential labor force during most of the 18th and 19th centuries.

The Urban Explosion

Prior to the Industrial Revolution, only a small percentage of the population of the world lived in cities with populations more than 5,000. As late as 1700, even in Britain, the most urbanized of the European nations, only 7 percent of the population lived in cities. The two largest cities of Europe were London, whose 550,000 people accounted for half of Britain's urban total, and Paris, whose 520,000 also accounted for nearly half the French urban population.

It was only toward the end of the 18th cen-

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tury that the modern movement toward rapid urbanization began to unfold. It is often said that the urban explosion was sparked by the expansion of the factory system, which absorbed the pool of unemployed urban labor. That proposition is misleading. During the first half of the 19th century, factories were powered primarily by water mills and hence had to be located at the fall lines of rivers, which were generally beyond the limits of the great cities. There were some cities, such as Manchester and Birmingham in Britain and Lawrence, Mass., whose growth was closely related to the growth of factories. But, in cities such as London, New York and Chicago, much more of the expansion of the labor force was related to trade, finance, government and other services.

Migration played a central role: the rapid growth of urban populations in the 19th century in both Europe and the United States was much greater than the natural rate of increase. Indeed, death rates in London, Paris, New York and other large cities were so high during most of the 19th century that, had it not been for massive immigration, these cities would have grown very slowly or even declined.

For Britain and continental Europe, the migration was mainly internal, from the rural hinterlands to the cities. In the United States, the migration into the cities was mainly intercontinental. However, it too resulted from an excess of agricultural workers in Europe. Peasants pushed off the land by labor-saving changes in technology first sought employment in the cities of their own countries, before making the dangerous journey to the New World. These great migratory movements were highly destabilizing – socially, politically and culturally – as is made apparent by the American experience.

Technological changes that greatly reduced the cost of ocean transportation were a major factor in inducing millions of Europeans to cross the Atlantic. Prior to 1810; the voyage to North America was long (about a month), dangerous (5 to 10 percent of voyagers died on the high seas, and another 5 to 10 percent died within a year of landing because of diseases contracted during the journey), and expensive (charges equaled to the annual income of a European laborer). Between 1810 and 1860, the time of the journey was reduced by 75 percent, the average risk of death as a result of the journey was reduced by up to 90 percent, and passage charges were reduced by 90 percent.

Technology also transformed inland transportation. The introduction of the steamboat in 1803 and improvements in steam engines greatly lowered the cost of transportation on inland waterways and made it economical to ship goods upstream on the Mississippi and Ohio river systems. Between 1817 and 1840, more than 3,000 miles of canals were constructed, improving passage on the Great Lakes and linking them to the navigable rivers. Millions of workers, tradesmen and their families, including many immigrants, migrated to the Midwest in search of economic opportunity. St. Louis, Cincinnati, Chicago, Detroit and Milwaukee sprang into being along these waterways.

The conquest of land was reinforced by the development of the locomotive, which permitted railroads to compete for commercial traffic. By 1840, some 3,000 miles of track were open to traffic in the United States; by 1860 that figure reached 31,000 miles.

Access to rich prairie soils in the Midwest greatly reduced the price of grains throughout the country, which was a boon to urban consumers but undermined the livelihood of farmers in the East. Unable to compete, farmers streamed out of the once-productive

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Connecticut River Valley during the 1840s and 1850s, seeking jobs in the often-glutted labor markets of Boston, New York, Philadelphia and other Eastern cities.

The misphasing of new technologies showed up even more dramatically in the lag of technologies needed for adequate housing, water supplies, sanitation and public health in large cities. That gap and its grievous effect on American society and culture must be considered in more detail to understand the recurring religious-political cycles.

Cities and Cultural Destabilization

During the first quarter of the 19th century, there was little tension between cities and the countryside. The nation was in the midst of an evangelical revival during which both religious and political leaders celebrated the virtues of a society of farmers and merchants organized around villages and towns over those of a society based on commerce and industries organized around large cities.

As late as 1820, Americans thought that they could avoid the corruption and political chaos that massive cities had introduced to European society. Manufacturing in the United States was still more a rural than an urban pursuit because mills and ironworks were located next to the waterfalls that provided their power. Although they were numerous and substantial by 1820, the new factories were not yet viewed as a threat to the agrarian ideal. It was still thought that, in a country like America, where, as Benjamin Franklin said, every man "can have a piece of land of his own," manufacturing was bound to occupy a small role in economic life. Experience had shown that few free men would willingly give up agriculture, in which they were independent, and look to manufacturing, in which they had to, as Franklin put it, "work for a master," for their livelihood.

It was still thought that few free men would willingly give up agriculture, in which they were independent, and look to manufacturing, in which they had to 'work for a master.'

Manufacturing, said Alexander Hamilton, secretary of the treasury under George Washington, was useful mainly because it gave employment to women, children, and, as Hamilton labeled them, *redundant* males. Indeed, most of the hands in the great textile mills were women and children. Such factories originally came into being in the United States only where large numbers of women and children from agriculture were underemployed. In tobacco and cotton regions, where pay for women and children in agricultural labor was relatively high, large textiles mills were uncompetitive, and only small handicraft shops producing fine cloth, and staffed by male hand-loom weavers, thrived.

All except the largest three or four cities were tightly knit communities that had not yet divided into class- and ethnicity-based neighborhoods, and they were walking towns, in the sense that all parts could easily be reached on foot. Even the two largest American cities in 1820, New York and

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Philadelphia, each with more than 100,000 inhabitants, fitted comfortably into the vision of America as an agrarian nation. They were large because their excellent harbors and access to the rural hinterland made them the best centers through which to export America's agricultural surpluses and import the foreign merchandise craved by American farmers.

Economic growth after 1820 did not change the fundamental relation between the cities and the countryside in the South. As late as 1860, barely 10 percent of the southern population lived in the cities. The change in the northern cities was, by contrast, a veritable revolution in culture. Not only did the urban population of the Northeast expand at an unprecedented rate, but also nearly half that population was concentrated in just two cities: Philadelphia and New York. By 1860, Philadelphia's population exceeded half a million, and New York's was close to a million. Although such large cities promoted certain elements of high culture and were showcases for new technology, it was not their achievements but the new problems they posed that attracted the most attention. Philadelphia, New York and Boston were perceived as threats to social order (because they bred disease, crime, violence and moral decay), to religious freedom (because they promoted godlessness and sin), and to popular democracy (because they promoted mob violence).

By the early 1840s, newspapers and government investigating committees were decrying the uncontrolled, unpunished spate of murders and riots, the commercialized vice, and the frequent robberies of both dwellings and businesses in the cities. Official estimates put the number of prostitutes in New York in 1844 at 10,000, some of them "not even into the teens." Drunkenness was widespread, with one saloon "for every 50 persons in the city over the age of 15." There was also a mounting problem of "vagrant and criminal children" (estimated by police at more than 3,000), some organized into rings of thieves by professional criminals.

The big cities of the 1840s and 1850s were not only incubators of crime and vice but also destroyers of the cultural vision of the founding fathers, who had warned that great cities would destroy the vigor of the Republic. By the late antebellum era, the prophetic metaphor had become a gruesome physical reality. Between 1790 and 1850, life expectancy in the North declined by 25 percent, and the decline in New York, Philadelphia and other large cities was twice as great. Life expectancy at birth for people born in New York and Philadelphia during the 1830s and 1840s averaged just 24 years – 6 years less than that of southern slaves.

This transformation of cities into death traps resulted from population growth that outpaced the development of adequate housing, sanitation and water. Thousands of lower-class families crowded into shanties. Older houses originally intended for single families were partitioned to hold three or more. Thousands more people moved into windowless underground cellars, where they had to share space with their own livestock as well as with omnivorous rats.

New Americans (mainly Catholics) glutted nonagricultural labor markets and greatly depressed the wages of Old Americans, creating one of the most severe depressions in the economic status of a major segment of workers in American history.

The Rise of the Professional Class

Technological change brought about still another shift in American culture, one that is more subtle but in many ways more far-

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reaching in its political effect than either migration or urbanization: that is, the vast increase in professional occupations and the associated changes in higher education. Professionals are experts in fields that require high degrees of training, usually obtained in universities. Professions often have regulatory bodies that certify the competency of individuals to practice the occupation.

Through most of American history, professionals constituted less than 3 or 4 percent of the labor force. Moreover, until the middle of the 19th century, professionals were overwhelmingly concentrated in three occupations: theology, law and medicine. As late as 1840, these three fields accounted for two-thirds of the graduates of American colleges and universities, with theology alone accounting for nearly a third of the output. It was not until the last quarter of the 19th century that the three original professions were overtaken by engineering, the sciences, education and a variety of commercial occupations.

The main aim of colleges established during the colonial period, beginning with Harvard College in 1636, was to train learned men to be ministers in one or another Protestant denomination. The teaching programs of these schools, and of most institutions of higher learning founded between the Revolution and 1900, were patterned after the liberal arts courses of Oxford and Cambridge. As the nation grew, the desire for higher education intensified. Institutions of higher education expanded from the nine established before the Revolution to more than 300 in 1860.

Most of the new colleges were church affiliated. Control of these colleges was vested in private, self-perpetuating boards, and the colleges were financed primarily through private philanthropy, religious organizations and tuition fees. At first, the new colleges offered traditional liberal arts, along the lines of the pre-Revolution colleges. But, as time wore on, they added courses in mathematics, moral philosophy and natural philosophy. College presidents were almost always ordained ministers, as were many faculty members. It was common practice for college presidents to teach a required course in moral philosophy, usually to fourth-year students.

The quickening of technological change in the late-18th and early-19th centuries made applied science an increasingly important part of higher education. France set the standard in 1795 with the establishment of the Ecole Polytechnique de France, which provided the engineers for Napoleon's armies. In the United States, technical education was stimulated by the Jefferson administration's ambitious program of canal and turnpike construction. In 1802, Congress voted to establish a corps of engineers with a training academy that was located at West Point. Additional engineering schools were opened in Troy, N.Y. (Rensselaer Polytechnic Institute, 1824), Brooklyn (Polytechnic Institute of Brooklyn, 1854), and New York City (Cooper Union, 1859).

The growth of scientific teaching within the denominational colleges was typified by Yale University, which established a chair in chemistry, mineralogy and geology in 1802. A medical department was created in 1810 and a school of engineering in 1852. In 1854, the courses in chemistry and engineering were combined into the Sheffield scientific school, which a decade later expanded to include the agricultural sciences and applied mechanical arts.

The establishment of state universities in the Midwest further promoted the secularization of the curriculum. The University of Michigan, for example, was founded in 1837

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under a charter that required it to be nonsectarian. Although biblical studies and daily worship were required of all students, the teaching program had a strong utilitarian component, reflected in courses in mathematics, chemistry, astronomy, zoology and medicine. Michigan was also the first state to fund a college of agriculture (1857), setting off a movement that culminated in the passage of the Morrill Land Grant Act of 1862. Under this act, each state received large quantities of public land to establish colleges teaching those branches of learning related to the agricultural and mechanical arts.

The modernization of colleges and universities before 1900 involved substantial secularization. Biblical studies remained, but the Bible increasingly was studied primarily as a literary or historical work, according to developing canons of literary and historical scholarship. Compulsory chapel often became interdenominational, with services focusing on ethical rather than theological issues. The prevalence of ordained ministers as university presidents dwindled. Even Princeton, the leading conservative Presbyterian university, elected a lay member of the church as president in 1902: Woodrow Wilson, the future governor of New Jersey and president of the United States.

By 1900, colleges and universities were poised for a vast increase in the demand for their product. In a sense, the reforms of the preceding half century had returned higher education to its original purpose, vocational training. However, in place of the one professional occupation – the ministry – post-Civil War leaders of higher education sought to produce people trained in all the professions demanded by the new technologies of the 19th century.

Interestingly, technological change increased the demand not only for scientists and engineers but also for graduates trained in the humanities, social sciences and business management. The explosive growth of high school education was a response to the high-technology industries of the late-19th and early-20th centuries (industries based in electricity, chemistry, and the first wave of office automation, printing and publishing), which demanded manual workers with a higher level of education. The 15-fold increase in high school students created a huge market for college-trained high school teachers.

The demand for graduates in the humanities was also related to the burgeoning growth of the mass media. During the last three decades of the 19th century, daily newspapers fell in price, increased the number of pages and the number of editions printed, ran drawings and photographs, and added literary material, gossip columns, cartoons, display advertising and separate editorials. Circulation boomed, expanding from under one million daily copies in 1870 to 42 million daily copies in 1929. Behind these developments were such crucial technological advances as high-speed rotary presses, the Linotype machine, color printing, photoengraving, and the array of technologies that promoted urban growth, including rapid transit systems, electricity, central heating and pasteurized milk.

Part of the growth in the demand for social scientists also came from the media.

However, the movement for social reform created an even bigger market for college graduates: the government. Labor bureaus, set up in numerous states and in the federal government, needed economists and sociologists to design and execute surveys of working conditions and standards of living. Similar skills were required by the Bureau of the Census, the U.S. Industrial Commission and

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the Interstate Commerce Commission.

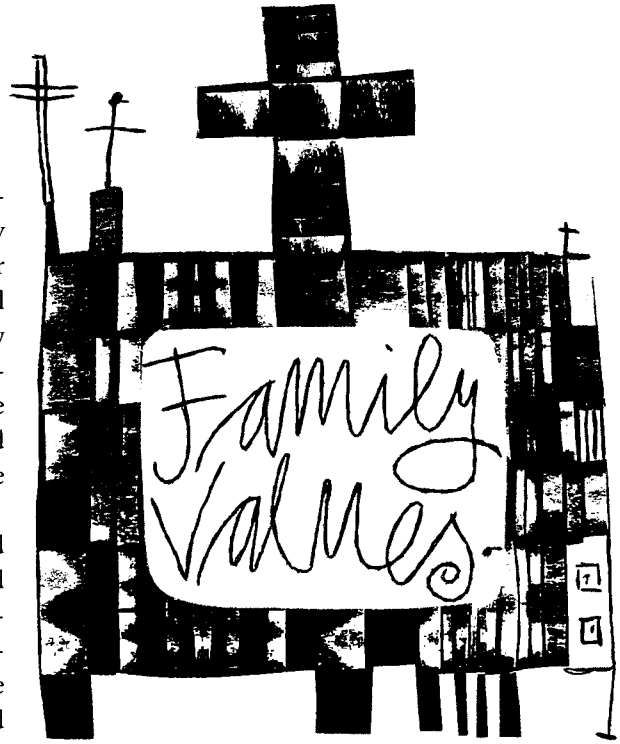
Businesses needed engineers and scientists. Chemists were in high demand not only by firms manufacturing dyes and other industrial chemicals, but also by the oil, steel and food-processing industries. Such new and rapidly growing industries as public utilities, telecommunications, railroads and the manufacture of electrical equipment and internal combustion engines demanded large numbers of engineers.

As businesses grew larger, more integrated and more complex, professionally trained managers began to replace the owner-manager (often an artisan). Some came out of engineering, some out of law, and some out of the schools of business management founded first at Pennsylvania in 1881 (the Wharton School). By 1915, some 40 business schools had been established.

Undergraduate enrollment at colleges and universities increased more than fourfold between 1870 and 1900 to 232,000, and it reached 1.1 million in 1930. The huge growth in enrollment resumed after World War II, going from 2.8 million in 1960 to 13.7 million in 1990.

As a result of this vast expansion in higher education, professional occupations in 1997 accounted for one-third of the labor force. The clergy, which dominated intellectual life in the 1890s, represents less than 1 percent of the professional class today. As if in answer to the appeals of the modernists, a secular class of experts on the natural and social worlds has usurped the monopoly that theologians once had on these domains.

The new professionals have played important roles in the establishment and perpetuation of the egalitarian state. They provide most of the personnel who manage the egalitarian state, both as designers and as implementers of policy. The government employs



one-fifth of all physical scientists, one-third of all life scientists, three-eighths of all mathematicians and more than a quarter of all social scientists. In addition to having a strong vested interest in the egalitarian state, professionals have an ideological predisposition toward it. The orientation is related partly to their professional training, which, in keeping with the egalitarian creed, emphasizes their obligation to serve society. Moreover, for many professionals, higher education has been a principal channel for upward mobility. They have therefore gladly accepted the role assigned to them by the principles of the Third Great Awakening: to guide society to a solution of the problems of poverty and social strife. Hence, they have taken the lead among those designing new policies and institutions that will permit the egalitarian state to fulfill its historic, if not divine, mission.

The Emergence of Technophysio Evolution

The synergy between technological and phys-

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iological improvements has produced a form of human evolution that is biological but not genetic, rapid or culturally transmitted, and not necessarily stable. Dora Costa, the MIT economist, and I call this process, which is still ongoing in both developed and developing countries, *technophysio evolution.*

Unlike evolution through natural selection, which applies to the whole history of life on earth, technophysio evolution applies only to the past 300 years of *human* history, and particularly to the past century. Despite its limited scope, technophysio evolution appears to be relevant to forecasting likely trends over the next century or so involving longevity, the age of onset of chronic diseases, body size, and the efficiency and durability of vital-organ systems. It also has a bearing on such pressing public policy issues as the growth in population, pension costs and health-care costs.

The theory of technophysio evolution rests on the proposition that, during the past 300 years, particularly during the last century, human beings have gained unprecedented control over their environment – a degree of control that sets them apart not only from all other species but also from all previous generations of Homo sapiens. This has enabled Homo sapiens to increase average body size by more than 50 percent, to increase average longevity by more than 100 percent, and to improve greatly the robustness and capacity of vital organ systems.

The most important aspect of technophysio evolution is the ongoing conquest of chronic, widespread malnutrition. Even the English peerage, with all its wealth, had a diet during the 16th and 17th centuries that was deleterious to health. Although abundant in calories and protein, aristocratic diets were deficient in vitamins and included large quantities of alcohol. The bad dietary habits of the peerage were probably most harmful to unborn children because ladies of the realm were apparently consuming the equivalent of three ounces of pure alcohol (seven ounces of 80-proof gin) per day.

Most people in 1700 were chronically malnourished, not because their diets abounded in toxic substances or were qualitatively deficient, but because of severe deficiencies in calories. In rich countries today, some 1,800 to 2,600 calories are available to fuel the work activities of a typical adult male. During the 18th century, France produced less than one-third the amount of energy for work that the United States now produces, and Britain was not much better off. Only the United States provided potential energy for work during the 18th century that is equal to its contemporary output.

One implication is that mature adults must have been very small by current standards and less physically active. Today, the average American male in his early 30s is 5 feet 10 inches tall and weighs 162 pounds. Such an individual requires about 1,800 calories daily to maintain body temperature and the functioning of vital organs when the body is fully at rest, and 2,300 calories for baseline maintenance. If either the British or the French had been that large during the 18th century, virtually none of the energy from their food would have been available to sustain work. Thus, to have the energy necessary to produce the national products of these two countries around 1700, the typical adult male must have been quite short and very light.

The Acceleration of Technological Change and Ethical Turbulence

The cascade of new scientific knowledge and new technologies that underlie the great improvements in the American standard of living, in health and in longevity during the

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20th century has also produced a series of ethical crises. Some crises, such as the heated debate over the right to life, do not depend on recent technological advances. Other disputes, however, are directly linked to new technological capacities far beyond anything previously contemplated.

Ultrasound, amniocentesis and other prenatal tests can reveal fetal abnormalities, raising the controversial issue of the termination of a pregnancy when such abnormalities are discovered. A related set of disputes turns on the use that may be made of placental tissue (the afterbirth) and of aborted fetuses. Is it ethical to use them for medical research or to supply cellular material to treat illness?

Medicine is not the only area in which new technologies have provoked public alarm. Although it is now established that the use of fossil fuel for heating and to generate electricity is resulting in the warming of the earth's atmosphere, the extent of this effect is still uncertain. Some fear that coastal cities will be flooded, but it is also possible that a warmer climate worldwide may have beneficial effects. Others worry that the use of genetic engineering to create wonder drugs and to increase agricultural productivity will inadvertently introduce deadly new organisms and produce new scourges.

The persistence of gloom, despite a credible record of achievements, suggests that the malaise about the economy is more moral and psychological than economic. Everything seems inadequate when measured against perfection. So even technology has become a symbol of failure, because it is incapable of delivering perfection. Moreover, the notion of balancing the benefits against the costs, so common to the thinking of physicists, chemists, engineers and economists, does little to quell the foreboding of those who seek assurance.

During the Second Great Awakening, the most disruptive new technologies were those that lowered transportation costs, spread the population beyond the Allegheny Mountains, and introduced the factory system. Lower transportation costs encouraged huge waves of Catholics from Ireland, and of Catholics and Lutherans from Germany and the Austro-Hungarian Empire to migrate to the United States. The synergism between the factory system and intercontinental migration promoted the rise of large cities, which became the focal point of ethnic riots and reshaped politics along ethno-cultural lines.

The principal technological changes after the Civil War were associated with increasing economies of scale, especially in railroads, utilities, petroleum refining, steel production, food processing and distribution, chemical manufacture and consumer appliances relying on electricity. These new large-scale industries required highly trained personnel, not only in the basic sciences, but also in business and engineering, to provide the managers needed to oversee complex production operations and to supervise the development of far-flung national and international markets. As a consequence of these new demands, professionals, who made up only a small fraction of the labor force at the beginning of the 20th century, represented close to one of three workers at the end of it.

The enormous advances in health and life expectancy during the 20th century also revealed the existence of synergies between the changes in technology and improvements in human physiology that ushered in the era of technophysio evolution. Whatever the advantages of technological progress to standards of living, there also arose severe dislocations in culture as a result of the lag in the adjustment of human institutions to the dramatic technological changes. The necessary

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adjustments were eventually brought about by political processes similar to those that have characterized the opening phase of the Fourth Great Awakening.

The Emergence of a Postmodern Egalitarian Agenda

At the dawn of the new millennium, two mighty camps of egalitarians are arrayed against each other. Disciples of the Third Great Awakening are determined to uphold the principle of equality of condition and to extend their progressive program of reforms. Disciples of the Fourth Great Awakening are equally determined to reinstate equality of opportunity as the reigning principle. Each camp champions an extensive list of moral and legislative reforms, one a response to modern industrial society, the other addressing new, postmodern concerns.

As important and as relevant as they are, the unrealized economic reforms of the Third Great Awakening cannot be the main elements of an egalitarian program for the era that is now unfolding. It is necessary to address such postmodern concerns as the struggle for self-realization, the desire to find a deeper meaning in life than the endless accumulation of consumer durables and the pursuit of pleasure, access to the miracles of modern medicine, education not only for careers but also for spiritual values, methods of financing an early, fruitful and long-lasting retirement, and increasing the amount of quality time available for family activities. Unlike the reform agenda of the Third Great Awakening, that of the Fourth emphasizes spiritual needs of life in a country where even the poor are materially rich by the standards prevailing a century ago, and where many of those who are materially rich are spiritually deprived.

Nor can legislative success be the principal measure of what is needed to continue the advance of egalitarianism in the decades ahead. Three of the principal programmatic demands of the Second Great Awakening (female franchise, prohibition and universal primary education) were embodied in law during the period in which the theories and programs of the Third Great Awakening surged to the forefront. Indeed, the reformist zeal promoted by the Social Gospelers reinforced the zeal of the reformers of the Second Great Awakening in bringing about many of the legislative victories of the late-19th century and the early-20th century.

The principal shortcoming of the later disciples of the Second Great Awakening was not a lack of compassion or good intent, but a failure to understand the limitations of a program shaped to deal with inequality in a largely rural society that was relatively homogeneous in terms of religion and ethnicity. Such a program was inadequate to deal with the problems of big businesses, industrial concentration and extended unemployment in a society that was highly urbanized and increasingly diverse in terms of religion and ethnicity.

The new equity issues in the United States no longer arise from the shock of rapid urbanization, the destruction of small businesses by competition from industrial giants, the massive destitution created by the prolonged unemployment of up to one-quarter of prime-aged workers, the disappearance of the frontier as a safety valve for urban unemployment and poverty, or the malnutrition and premature death of the great majority of urban workers and their family members. Quite the contrary, the new issues are to a large extent the product of the *solutions* to these problems, achieved by a combination of economic growth and the successes of the reforms advocated by the Social Gospelers,

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their allies and their successors.

The emerging egalitarian crisis arises partly from the fact that people are living much longer than they did in 1900, and that life spans will likely continue to increase for the foreseeable future. The emerging crisis is also related to the changing nature and distribution of work and leisure – changes so drastic that our current vocabulary is inadequate to describe them.

The new crisis also has to do with enormous changes in the structure of consumer demand, which are creating overabundance in some areas (such as the excessive consumption of calories and fat) and severe shortages in others (such as health services). It also has to do with those adolescents and young adults whose education and vision leave them unable to cope with this new world or to share in its abundance, effectively estranging them from the mainstream.

The problem of self-realization has distinct aspects, and different solutions, for the young and the aged, for ethnic and racial minorities, and for women, yet all fuel the moral crisis that is the hallmark of our age and the greatest threat to the survival of our society. To achieve self-realization, each individual must have an understanding of life's opportunities, a sense of which of these opportunities are most attractive at each stage of life, and the requisite educational, material and spiritual resources to pursue those opportunities. In the era that is unfolding, fair access to spiritual resources will be as much a touchstone of egalitarianism as access to material resources was in the past.

Spiritual resources are not limited to those found in the sacred realm, but include the whole range of immaterial commodities that are needed to cope with emotional trauma. Such resources encompass a sense of purpose, a sense of opportunity, a sense of community, a strong family ethic, a strong work ethic and high self-esteem. Although the majority of Americans, especially those over 40, find many of these resources in religion, there are numerous other codes of behavior and theories of life that inspire virtue and lead to success in coping with modern life.

It is necessary to address such postmodern concerns as the struggle for self-realization, the desire to find a deeper meaning in life than the endless accumulation of consumer durables.

Severe inequality in the distribution of spiritual resources results in part from changes in the structure of the economy and of social institutions through which immaterial resources are transferred. Spiritual deprivation is due in part to the glorification of hedonistic impulses and instant gratification by the media and advertising; this has diverted many children and adolescents from the quest for self-realization. Also involved are the improvements in human physiology that have contributed to the rapid growth of the elderly population, without an adequate corresponding growth in social institutions to minister to their needs.

The growth of the elderly population has given rise to the problem of intergenerational equity, which now looms as a barrier to the

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self-realization of both older and younger cohorts, and which threatens to become the most divisive issue of the era that is unfolding. Intergenerational equity involves not only the assurance of appropriate standards of living at different stages in the life cycle, but also the assurance that one generation will not be made to suffer a disproportionate share of the burden of financing a lifetime of self-realization.

Lifelong learning is another new equity issue. It involves, first of all, greater access to college and to technical education, through the bachelor's degree or its equivalent, for adolescents and young adults. Also needed is a higher level of training in technical skills for high school and junior college graduates unable to undertake the bachelor's degree. Lifelong education for adults in midlife should offer opportunities not only to upgrade skills required to earn a living but also to extend knowledge in the arts and humanities, an important part of self-realization and an essential aspect of accumulating spiritual resources. By far the most severe educational inequities, and the most difficult and expensive to solve, are those that afflict the elderly.

To many disciples of the Third Great Awakening, *spiritual equity* is a red flag that conjures thoughts of reactionary assaults by the religious right. Like it or not, the reform agenda spelled out by the religious right, with its focus on the restoration of the traditional family and its emphasis on equality of opportunity, more fully addresses the new issues of egalitarianism than does the agenda of the Third Great Awakening. The upsurge of religiosity associated with the Fourth Great Awakening is inspiring millions who have experienced religious revival to minister to the alienated young and the depressed elderly, to counter the drug, tobacco and alcohol cultures, and to reinforce the traditional family.

Those who are suspicious of, say, the Promise Keepers, or dislike some planks of the Christian Coalition's Contract with the Family, should not throw the baby out with the bath water, but should organize their own movements to reinforce stable families, to provide mentors to alienated young people, to provide moral support for single mothers, and to enrich the lives of preschool children.

If properly integrated, the unrealized aspects of the egalitarian agenda of the Third Great Awakening and the new agenda of spiritual reforms will become mutually reinforcing. For women, self-realization requires an end to glass ceilings and the creation of conditions that make careers and families fully compatible. For African-Americans, self-realization requires not only an end to discrimination, but also training and the spiritual resources that will enable those who are alienated to compete successfully for mainstream economic opportunities. For all those in poverty, education that provides the technical and spiritual endowments needed for successful competition in the rapidly changing economy is a necessary condition for self-realization.

The divisive disputes over the urgency of supplying material and immaterial needs could become a major obstacle to progress – as occurred a century ago, when the two main egalitarian camps of that era, the traditionalists and the modernists, assaulted each other. The problem is not merely one of recognizing the salience of the new spiritual issues (including international equity) and, in some cases, their political precedence. It is also necessary to reformulate some of the older analyses and solutions to take account of changes in the structure of the economy and in the desires of consumers at all levels of income distribution. M

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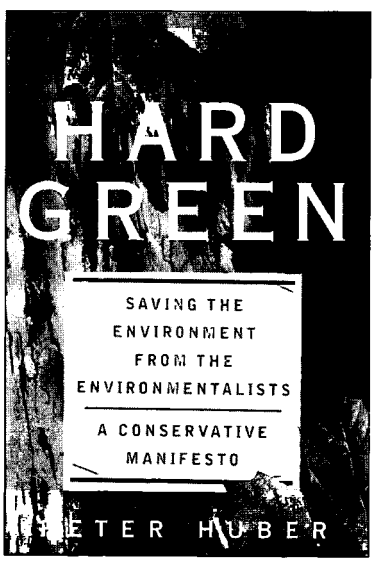
Peter Huber's *Hard Green* is an interesting, important and challenging book. Interesting and important because the polymath Huber (nuclear engineer from MIT, summa cum laude graduate of Harvard Law School, antitrust consultant and science policy expert) writes very well about something that matters – namely, the future of global environmental policy. Challenging because the book requires at least some familiarity with philosophy, science, economics and religion to appreciate Huber's central argument.

Hard Green: Saving the Environment from the Environmentalists

by Peter Huber

Basic Books, 204 pp. $25

Reviewed by Paul R. Portney



Hard Green is in some ways a hard book to like. While no rant, the book has a vaguely dyspeptic quality to it, perhaps a reaction to the disingenuousness Huber sees in the high priests of the environmental movement. Vice President Al Gore will really dislike this book.

But because Huber sets out a conservative environmental vision and because he contrasts it with a vision he attributes to Greenpeace-like environmentalists – and, presumably, many Democrats – his book is especially interesting to read during an election year. This is not to suggest that *Hard Green* is a partisan screed. Huber is sure to render western Republicans positively apoplectic when he writes of President Clinton's decision in 1998 to designate an enormous swath of land in Utah as a national monument: Theodore "Roosevelt would have understood the controversy over Kaiparowits Plateau and approved, not just the decision to conserve, but the in-your-face political courage it required."

Teddy Roosevelt, you see, is the embodiment of the "hard green" environmentalism that Huber espouses. On the one hand a cattle rancher and big-game hunter par excellence, Roosevelt was also the president who added 150 million acres of land to the national forest

PAUL PORTNEY is the president of Resources for the Future, a nonpartisan environmental think tank in Washington.

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system and began pitching land conservation to his fellow citizens. Huber urges we do much more of the same. And here he finds common ground with not only Bill Clinton and Al Gore, but also George W. Bush. For, like his father, Dubya would expand the Land and Water Conservation Fund so that governments at every level might step up significantly their acquisition of land for conservation purposes.

inefficiencies of recycling and bind up carbon in a "mummified" state safely below the surface of the earth.

Wait just a minute here. This is as far as environmental policy goes? What about air or water pollution control, the control of pesticides and toxic substances, the remediation of contaminated sites, the provision of safe drinking water and the like? Is there no role for EPA-type environmental regulation in the hard green vision? This is where that conspic-

Nuclear power will enable us to minimize disruption of the ecosystems; biotechnology will permit us to grow more food on less land.

Where Huber parts company sharply with "soft greens" (the Sierra Club, Friends of the Earth, etc.) is that, with one conspicuous exception, conservation is what he thinks environmental policy ought to consist of – the preservation of vast areas of wilderness unsullied by commercial enterprise. End of story.

No hand wringing over resource scarcity, no technophobia regarding genetically modified organisms, no gnashing of teeth about nuclear power, no wearing of hair shirts on account of prodigious consumption. In fact, on most of these counts, Huber sees solutions where soft greens see problems.

To wit: nuclear power will enable us to minimize disruption of the ecosystems; biotechnology will permit us to grow more food on less land, thus both raising living standards for the poor and allowing more land to revert to wilderness; still other technologies will enable us to reduce the environmental impacts associated with manufacturing, forestry or agriculture. Even the much-maligned landfill will help us avoid the

uous exception comes in.

In response to the cry that unfettered markets will produce too much air and water pollution, "the soft greens are simply right," Huber says. "They have an unanswerable case for government intervention of some kind." And though he would favor an enlightened approach to the control of gross air or water pollution – creating "rights" to emissions and then allowing those rights to be bought and sold in free markets, Huber does recognize the need to control some pollution.

But Huber quite clearly would stop far, far short of the point to which soft greens would go. Although he is a bit oblique on the question, it seems that Huber is quite willing to limit air and water pollution well below the levels of the late 1960s – a time, remember, when Cleveland's Cuyahoga River spontaneously combusted and Los Angeles's air quality was on a par with Mexico City today. In his words, "Hards agree that abating large, serious, well-defined sources of pollution is efficient and green." Put differently, Huber's hard green manifesto finds such visible

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affronts clearly unacceptable, so long as they are addressed in the right way – again, through the creation of markets rather than, say, through technology mandates emanating from the Environmental Protection Agency.

What about the less palpable pollution problems – those associated with trace quantities of chemicals in drinking water, pesticides in food, or possible carcinogens in the air? Here Huber and his fellow hard greens part company with today's more recognizable environmentalists. Huber's hard greens are reluctant (if not loath) to take action against such things as dioxin, PCBs, DDT, suspected "environmental estrogens," carbon dioxide and other chemical hazards in the air and water, on land and in food.

The reason? The evidence linking these substances to adverse health or ecological effects is much less certain (of which there can be no doubt) than that associated with the grosser pollutants. At the risk of some oversimplification, Huber's view seems to be: "When we could see, taste, smell and almost touch pollution, it was obviously time to do something about it. That's not the case anymore, so we ought to be awfully careful not to regulate unless we're sure we'll do more good than harm."

Truth be told, that's a pretty good rule. But it does raise very difficult questions that Huber doesn't answer to my satisfaction.

Suppose a carefully done epidemiological study suggests that ambient concentrations of di-nitro-chickenwire are positively and statistically significantly associated with premature mortality. Suppose other studies, based on different populations and cities, find the same effect. *Hard Green* reads as if this would not be enough evidence on which to base a new regulation because these statistical associations could be spurious.

In fact, Huber points out that statistically significant associations are routinely ignored by the EPA and other regulatory agencies when they imply that higher concentrations of certain pollutants reduce rather than increase the incidence of particular diseases. Since these are presumably statistical flukes, Huber suggests that positive associations between cancer, say, and exposures to pollutants could also be flukes.

It would be most helpful, though, if he had suggested the point at which it would no longer be prudent to ignore such associations. After 30 years of pollution control at large factories, power plants, refineries, steel mills and sewage treatment plants, the gross pollutants have been pretty well controlled. (Water pollution from agriculture is the major exception.) This leaves the more difficult cases, and *Hard Green* would be an even better book if it offered a little more guidance as to where the tipping point between inaction and action should lie.

Similarly, Huber seems to suggest that we ought to shy away from regulating pollutants that nature itself produces in abundance: particulate matter (windblown dust), carbon dioxide (decaying trees), pesticides (produced more potently by plants than by man), radiation (the earth and sun) and, presumably, sulfur dioxide (volcanoes).

Sulfur dioxide was one of the grossest of the air pollutants that the new EPA regulated beginning in the early 1970s, an intervention that Huber appears to support in *Hard Green.* Should we doubt the wisdom of this intervention because Mount St. Helens or Mount Pinatubo is capable of producing more sulfur dioxide in one eruption than all the power plants in the world in a single year? Even if anthropogenic emissions are picayune compared with natural sources, should we not still ask how much good it would do to limit them still further and how this good compares with

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the cost of doing so? Huber says less about such knife-edge decisions than he might.

Huber is at his best when he is most provocative. Once again, though his sharpest gibes are aimed at the left, he will infuriate those who believe that markets or private land conservation efforts are sufficient to the task. He writes: "In every way an accountant, economist or even an ecologist might measure, Disney would operate Yellowstone much better than the National Park Service. But Yellowstone would be diminished nonetheless. A vital part of its grandeur, and our own, is that it belongs not to Wall Street but to America. Values that inhere in citizenship, nation, patriotism: Such values cannot be contained or conserved in any private market. With such things, to privatize is to destroy."

In every way an accountant, economist or even an ecologist might measure, Disney would operate Yellowstone much better than the National Park Service.

To be clear, Huber favors preservation of these lands in the sense that John Muir intended the word: apart from recreation (which may include some hunting) he does not intend these areas to be managed in such a way as to allow timbering, ranching, mining or other commercial economic activity. According to Huber, "When government has attempted to balance conservation with strictly economic interests, it invariably manages to despoil the land and dissipate the economic opportunities, too."

Hard Green has a very hard edge, indeed. Soft greens, in Huber's view, are bundles of inconsistencies. They find air and water pollution abhorrent, yet are complicit, as fellow travelers with the liberals in the entertainment world, in the "pollution" of radio, television and the movies. They often resist the use of property rights as a solution to environmental or natural resource problems, yet seem willing to fight to the death for a woman's right to assert dominion over her own body. They are suspicious of most new, complex technologies, yet use extraordinarily complicated computer models to justify intervening in energy or other markets out of concern for global warming or stratospheric ozone depletion.

Huber mocks those who suggest that we will run out of raw materials, those who suggest market capitalism is the cause of environmental collapse (Eastern Europe and the former Soviet Union make this a difficult case to prosecute, one must admit), and, most of all, those who would stand in the way of newer, more environmentally benign technologies in the name of the environment.

I said at the outset that Al Gore would really dislike this book. He ought to read it anyway. So, too, should George W. Bush, many of whose supporters will be put off – to say the least – by some of what Huber has to say. While *Hard Green* rankled me at times with its policy prescriptions and, sometimes, with its florid prose, it also made me think about what sensible environmental policy means to me – and why. You could do a lot worse these days. MI

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Lend an eye once more, economists and fellow travelers, for this issue's compendium of interesting research that you aren't likely to catch elsewhere.

THAT HALF-EMPTY WATER GLASS

Foreign direct investment, we've all come to learn, is safe and healthy investment. Unlike portfolio equity investments (mostly mutual funds) or loans, it comes with a long-term commitment and, often as not, with foreign technology and skilled personnel.

By that metric, Latin America is a very healthy place to invest: last year, 97 percent of all private capital flowing to the region was in the form of foreign direct investment – up from about 40 percent in 1996.

But Ricardo Hausmann and Eduardo Fernández-Arias of the Interamerican Development Bank think this conventional wisdom is exactly backward. The preponderance of foreign direct investment in Latin America (and in Asia, too, since the financial crisis), they say, is a sign of weakness – of the failure of weak domestic institutions to support any alternative to the form of investment that offers the most hands-on control by foreigners. Want proof? Consider the fact that just 12 percent of capital flows to the stable industrialized countries is in the form of foreign direct investment.

It's a neat point – one derived from Ronald Coase's famous essay on the theory of the firm. Production within the corporate umbrella, Coase noted, is really a substitute for production through less efficient decentralized markets. By the same token, the international extension of the corporation as a source of capital, skills and technology is an implicit acknowledgment of the inefficiency of local markets.

But don't misunderstand: the shift in financing from debt and portfolio equity to direct foreign investment in the last few years is a welcome trend precisely because it recognizes that other forms of capital transfers couldn't be supported. A shift back to debt wouldn't represent an advance unless it reflected reduced risk and more efficient local institutions. [*"Foreign Direct Investment: Good Cholesterol?" Research Department Working Paper #417, Interamerican Development Bank. Download free from www.iadb.org/oce/324.cfm.*]

EUROPE'S HIDDEN FISCAL MESS

For countries joining the European Monetary Union, part of the deal is putting their fiscal houses in order. Each year, euro-area members must publish reviews of their macroeconomic-stability programs, outlining fiscal objectives for the next three years. These reviews are available to the public. The latest ones have also been analyzed by the IMF staff – and thus offer a more candid view than any internal analy-

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sis by the European Union is likely to provide.

Actually, the anonymously authored IMF "staff country report" offers considerably more: historical perspective on how Europe dug itself a deep fiscal hole, plus summary tables with contemporary data that permit country-to-country comparisons. The report provides, in effect, one-stop shopping for those who want to know how budgetary restructuring is progressing in Europe.

The IMF's conclusions are disturbing. While monetary union members have all been able to trim deficits and may be able to balance their budgets by 2003, the medium-term future is cloudy. For one thing, much of the anticipated budgetary improvement turns on low interest rates and a vibrant economic recovery – neither of which is a sure thing. More important, fiscal stability is only possible because tax rates remain very high, and high tax rates are not conducive to long-term growth. The real crunch will come in about a decade, when the first of the baby boomers retire and attempt to draw their state pensions. [*"Monetary and Exchange Rate Policies of the Euro Area – The Euro Area Stability Programs," IMF Country Report 00/63 Download free from imf.org/external/pubs/cat/longres.cfm?sk=3550.0.*]

The Great Society Lives

With Dubya and Al each jockeying for turf in the political middle, these are hard times for advocates of old-fashioned interventionist government. In this post-ideological environment, government is still supposed to spend money, but mostly on those who already have some – old folks, farmers, defense contractors. That makes the most recent evaluation of the Job Corps, surely the most expensive program left from Lyndon Johnson's war on poverty, all the more striking.

According to Mathematica Policy Research, a for-profit (but squeaky clean) research company, dead-end teenagers who spend eight months in a residential training and education program run by the Job Corps are noticeably better for the experience. Specifically, 16- and 17-year-old boys earn about one-fifth more than a control group, and are one-fifth less likely to be arrested.

Does the Job Corps "pay," in the sense that the $20,000 cost per enrollee is more than offset by reduced outlays for welfare, prison, food stamps and the like? Mathematica is working on the question. But even if it doesn't, the $1.3 billion program represents one of a handful that actually does something concrete for the young and very poor. What's not to like? [*Peter Schochet, John Burghardt and Steven Glazerman, "National Jobs Corps Study: The Short Term Impacts of Job Corps on Participants' Employment and Related Outcomes." Download free from www.ttrc.doleta.gov/opr/FULLTEXT/jobcorps/Outcomes/.*]

WITHER BILL G AND COMPANY?†

The Department of Justice, much of the American media and, most important, Federal District Court Judge Thomas Penfield Jackson, want to break Microsoft in two.

Do you care? Should you care? The polls suggest that America's opinion elites – in particular Silicon Valley types – are in favor of anything that wipes the smirk off Bill Gates's face. Pretty much everybody else has a positive view of both BillG and the software company that he runs. But hardly any-

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Who Pays for Inflation?

Richard Nixon called inflation "the cruelest tax." And while he was probably referring to the fact that unanticipated price increases function as an arbitrary levy on people living on fixed incomes, economists often think about the point in another context: the failure to achieve price stability and the ensuing anti-inflationary crunch, they argue, often hurt the poor more than the rich.

William Easterly of the World Bank and Stanley Fischer* of the International Monetary Fund offer two forms of evidence on the subject. First, they used 1995 polling data from 32,000 households in 19 industrialized countries and 19 less-developed countries to show that the poor are more likely to view inflation as a major concern.

Of course, it's possible that the poor don't understand where their real interests lie. Indeed, it was once populist gospel that inflation favored the poor. A century ago William Jennings Bryan was able to mobilize millions of rural poor with the slogan that they were being crucified on a "cross of gold" – a reference to the gold standard that generated deflation during the late 19th century. Bryan's banner was taken up in recent times by leftists who view the Federal Reserve as an instrument of the rich. The poor are more likely to be debtors, the argument goes, and inflation reduces the real value of their debts.

Easterly and Fischer test the proposition directly, using cross-country data from the 1970s, 1980s and 1990s. And the while the effect of inflation on income distribution isn't all that powerful, the poor are relative losers. On average, going from stable prices to hyper-inflation would reduce the share of national income going to the bottom fifth of the income distribution from 6.2 percent to 4.5 percent. [*"Inflation and the Poor," World Bank Policy Research Working Paper 2335. Download free from www.worldbank.org/research/workpapers.nsf.*]

**Yes, the Stanley Fischer, the IMF's equivalent of a chief operating officer.*

body seems to understand the Justice Department's allegations or Microsoft's defense.

This monograph is somewhat dated because it was written before Judge Jackson threw the book at Microsoft. But it does offer compact, relatively easy-to-read versions of economic issues, which will figure prominently in arguments before the appeals courts. The government's side is carried by Dan Rubinfeld, the chief economist at the Justice Department's Antitrust Division, and Frank Fisher, an economist from MIT who served as the government's chief economic witness in the trial. David Evans, a senior VP at National Economic Research Associates, and Dick Schmalensee, the dean of MIT's Sloan School and Microsoft's chief economic witness, defend Microsoft. [*"Did Microsoft Harm Consumers? Two Opposing Views," AEI-Brookings Joint Center for Regulatory Studies, $10. Purchase from www.aei.brookings.org/publications/.*]

*In the interest of full disclosure, I am a consultant to Microsoft. — pp

IS THE UNITED STATES READY FOR CURRENCY UNION?

Most politicans and political scholars loved the idea of the European Currency Union. But economists were deeply divided. On one side

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stood those who believed that the resulting commitment to fiscal and monetary discipline would pay off big for countries on Europe's periphery – notably Italy, Spain and Portugal, where investors have long demanded premium returns to compensate for allegedly greater risk associated with currency instability. On the other side were economists (among them, Martin Feldstein of Harvard and Larry Lindsey of the Bush presidential campaign) who worried that one-size monetary policy would not fit all.

The jury is still out on the EMU, though it's already apparent that the union is split on the question of how much output and growth should be sacrificed in order to reverse the depreciation of the euro. What about other currency unions? The biggest, most important – and least examined – is the one that binds the 50 states of the United States in perpetual monetary embrace. And in a fascinating paper, Hugh Rockoff, an economic historian at Rutgers, provides an assessment.

Rockoff offers a number of historical examples in which monetary union produced interregional conflict. Only in the 1930's were the politics and economics of union driven underground – and then, only because the federal government began to make huge fiscal transfers to regions at greatest peril from tight money. In recent decades the problems have been further eased by the relative mobility of labor – if you can't get a job in West Virginia, Texas or California, Florida is only a few hours and a few hundred dollars away by plane.

But Rockoff remains skeptical that the benefits have outweighed the costs. "The survival of the U.S. monetary union," he writes, "is at best muted evidence that the net effects have been positive." [*"How Long Did it Take the United States to Become an Optimal Currency Area," National Bureau of Economic Research Working Paper H124. Download (for a fee) from www.nber.org.*]

THE DUTCH (AND BRITISH) EMPLOYMENT MIRACLE

For all the focus on monetary union, the great economic issue facing Europe is unemployment. For decades unemployment has hovered near 10 percent even in good times, and the consequences for young workers have been close to disasterous. The left-center governments of Germany and France, the economic powerhouses of the continent, make noises about labor market reform, but haven't achieved much.

That makes the Dutch

Democracy Wins Again

So, when the bean-counters from the International Monetary Fund show up, demanding fiscal restraint in return for emergency loans, who bears the burden? Mohsen Fardmanesh of Temple University and Nader Habibi of Yale have published a neat little paper that breaks down the impact of budget cuts in some 70 countries in the 1980s, according to a handful of sociopolitical criteria.

It turns out that the higher the level of democratic participation, the greater the vulnerability of the bureaucratic and defense sectors, as compared to social spending and the productive economy. Putting it bluntly, democracy weakens the power of the military and the central bureaucracy. [*"What is Vulnerable During Fiscal Retrenchment?" Economics and Politics, March 2000. To buy single copies, e-mail jnlinfo@blackwellpublishers.co.uk.*]

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The Embarassment of Riches

Last December, the Federal Reserve Bank of New York convened a Who's Who of economists to assay the impact of large and growing government budget surpluses.

Alan Auerbach of the University of California (Berkeley) led off with an overview of how Washington dug itself into a fiscal hole in the early 1980s and dug itself out over the following 15 years. Eugene Steuerle of the Urban Institute pointed out that the current surplus represents "the eye of the storm," a respite from fiscal red ink that will flow again unless the baby boomers renounce their pension rights. Darrel Cohen and Glenn Folette of the Fed politely quarreled with Olivier Blanchard of MIT on the degree to which current budget outlays and taxes lean against the wind – that is, offset ebbs and flows of private demand across the business cycle.

Then the conferees plunged into a brand-new area: the impact of the shrinking supply of Treasury securities. Will all that black ink undermine the role of federal debt in providing both liquidity and a benchmark for assets that effectively carry no risk of default?

A good time was had by all. And you can share in it (for free) on the Web or by ordering the recently published conference volume. [*"Fiscal Policy in an Era of Surpluses: Economic and Financial Implications," Economic Policy Review, Volume 6, Number 1. Download free from www.ny.frb.org/rmaghome/ econ_pol/2000.htm.*]

and British experiences all the more remarkable. Starting at the same (wretched) place as the rest of Europe in the 1970s, they have both managed to reduce unemployment to manageable levels. And they have even been able to draw new workers – mostly women and the younger elderly – back into the labor force.

How did they do it? Economists agree that a broad list of reforms have changed the labor markets in the two countries – cuts in unemployment benefits, deregulation of part-time work, cuts in labor taxes, etc. – but they haven't come to any accord on the relative importance of the reforms.

Steve Nickell of the London School of Economics and Jan van Ours of Tilburg University in the Netherlands take a hard look at the explanations and come up with a ranking. Most of the cut in unemployment in both countries, they argue, has come from changes in wage bargaining with unions. But for very different reasons. In the Netherlands, the government made a deal with the unions in 1982 that left organized labor with considerable power. In Britain, by contrast, union power was broken by changes in labor laws and a subsequent decline in union membership.

Which route was more successful? The Dutch model sure looks better to continental politicans, who would always rather deal with unions than fight them. But Margaret Thatcher's confrontational style may, in the end, have put Britain in a better position. For even as we speak (write?), Dutch unions are becoming restless with small wage increases in an era of a labor market with just 3 percent unemployment. [*"The Netherlands and the United Kindom: a European Employment Miracle?" Economic Policy, Volume 30. To obtain a copy, check out www.blackwellpublishers. co.uk*]

—Peter Passell

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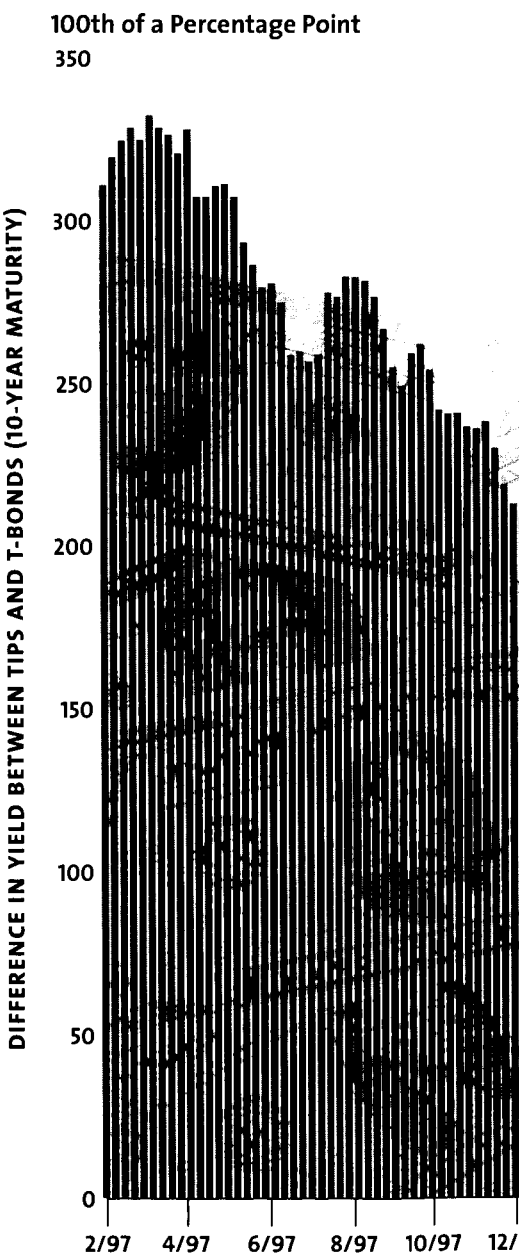
Worried about inflation? You and Alan Greenspan. But unlike Chairman Alan, you can't do anything about it.

Actually, that's not quite true. For the last three years, the U.S. Treasury has been selling notes and bonds whose principal is indexed to the consumer price index. And the market-determined price of protecting investments in Treasury securities against inflation has proved remarkably low: as of early July, so-called TIPS (Treasury Inflation-Protected Securities) were a breakeven proposition if inflation runs just over 2 percent for the next decade. That is, if inflation exceeds 2 percent, a 10-year TIPS will have proved a better deal than a 10-year Treasury bond.

If inflation is lower than 2 percent, of course, the plain-vanilla bond will pay a higher return. Still, this isn't a bad deal. Or, to put it another way, the market's expectations of inflation are so low that few investors are willing to pay a significant premium over the recent inflation rate for inflation insurance.

—Thanks to Tom Hall of The Milken Institute Capital Studies Group



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Inflation Insurance On Sale, Cheap.

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BY LEON BIJOU AND GLENN YAGO

The development of the Middle East depends upon both the political and the economic peace processes. The political process, involves the resolution of the issues between Israel, Lebanon, the Palestinian Authority and Syria, which include transferring land, establishing mutually recognized borders, allocating scarce water resources, and resolving the status of Jerusalem.

The economic process has attracted less attention, but may ultimately prove to be just as important. It involves normalizing trade and investment relations among Israel, Egypt, Jordan, Lebanon, Syria and the Palestinian Authority, as well as embarking on joint infrastructure and business development projects. In the *realpolitik* of the Middle East, the two processes are interdependent, so that the resolution of the former will determine whether economic normalization can achieve its full potential. Simultaneously, the absence of economic growth for Jordanians, Egyptians and Palestinians would create despair about the peace process.

The political process progressed fitfully throughout the 1990s. But, despite a plethora of proposals and some very compelling incentives, there have not been any successful cross-border infrastructure projects. The most obvious cause for this lack of progress is Israel's failure to resolve sovereignty disputes with the Palestinians. The less obvious cause is that central governments have borne full responsibility for both making peace through the political process and building through economic normalization. And while political negotiations are the quintessential "zero-sum game" – two countries can't control the Golan Heights – economic cooperation is all about transactions that can benefit all. Rather than acting in both capacities, the central governments should encourage the involvement of the private sector and local governments in the economic peace process.

Including the private sector in cross-border economic development would allow the central governments to exploit that sector's resources and experience. And by granting a role to the local governments, the central governments can permit cross-border cooperation to be managed by those most familiar with their citizens' daily lives. In neither case would national priorities be neglected.

To accomplish this decentralization and privatize the peace process, central governments need to recognize their own institutional limits. As a practical matter, that means limiting government's role to serving as facilitator by passing the laws and regulations that

LEON BIJOU is an attorney in New York specializing in economic development finance in the Middle East. **GLENN YAGO** is director of capital studies for The Milken Institute.

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create a fertile environment for markets. With respect to local governments, the central governments can promote and support projects that are initiated at the local level. More specifically, it would make sense to:

Liberalize and deregulate local markets and industries to attract investors and promote competition. As has been proven worldwide, lowering barriers to movements of capital, people and goods across borders offers the added benefit of attracting foreign direct investment – the lifeblood of the burgeoning global economy. Business people throughout the region are an excellent source of information on what needs to be corrected on the micro level. Of course, businesses now benefiting from existing trade barriers may face stiff competition from foreign competitors. But that's a small price to pay for the overall benefits of foreign economic engagement.

Support local governments' cross-border initiatives. Throughout the region, mayors and local planners envision the opportunities that could become available once the political peace process has been completed. Cross-border cooperation offers a chance to extend regional economic development despite the existence of a sovereign border. Such projects include transportation, water and sanitation, education, tourism and health.

Establish bi-national public authorities. In the case of large infrastructure projects that traditionally have been public, central governments would have to create an institutional framework. In other parts of the world, transportation, energy and telecommunications projects are being privatized. But that may not be a realistic option where the permanent state of war has created risks unacceptable to long-term investors. Bi-national public authorities could be pivotal in two respects. With sufficient autonomy, such entities may operate on a commercially viable basis and, perhaps, be privatized in the future. A bi-national public authority might also borrow money from local and international capital markets, thereby relieving central governments of a major financial burden.

Create financial vehicles to invigorate capital markets. Shifting the burden of funding projects from the central governments to the public capital markets would allow more projects to be funded. To that end, it would be necessary to create financial vehicles that serve as conduits.

In the United States, government authorities issue development bonds at preferential interest rates. They then lend the proceeds to developers, who use the capital to finance infrastructure. The developer reimburses the bondholders when the bonds mature. The governmental entity serves as a conduit between the capital markets and the borrower (for the initial borrowing), and the borrower and the investors (for the repayment). Municipal bonds are another financial vehicle that can relieve central governments of the financial burden for all infrastructure projects.

Leverage donor funds. Rather than using limited donor funds, whether for the Palestinian Authority or in Israel, to pay for bricks-and-mortar, those funds could be used as leverage to attract capital to the region on a commercial basis for cross-border peace projects and economic development. For example, donor funds could go into reserve accounts or guaranty funds for debt issuances, creating additional security for bond buyers and, of course, lowering the cost of the capital to the borrowers. In addition, donor funds could be used to finance the upfront capital costs of infrastructure projects, which could then be operated by the private sector. This would allow the private sector to make a profit on projects that, otherwise, would be unprofitable. M

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COMPETITION TO AWARD $2,000 PRIZES

The Milken Institute will award prizes of $2,000 to each of four winners in its second annual economic research competition.

The Milken Institute Award for Distinguished Economic Research honors the best papers in each of its four study areas: capital studies, global studies, labor markets and human capital studies, and regional and demographic studies. Papers must address an issue in at least one of these areas, and be written in a style that is clear to a well-informed member of the business, finance, economics or policy community, as well as to an academic audience. The maximum length is 7,500 words. The contest is open to all – teachers, students and practitioners.

The deadline for submitting papers is Dec. 31. For more information about the Award, including submission requirements and copies of last year's winning papers, go to www.milkeninstitute.org or call 310-998-2600.

CONFERENCE LOOKS AT CALIFORNIA'S ECONOMIC FORTUNES

At its second annual State of the State Conference, on Oct. 18, The Milken Institute will take an in-depth look at the California economy.

Thanks to its strong technology base, proximity to Latin American and Asian markets and the extended economic expansion in the United States, California has recovered from the severe recession of the early '90s. But will the good times last? What sectors of the regional economy are most vulnerable? And what signs of a recession in the offing should be taken seriously? This day-long event will address those and other questions about the state's economic future.

The conference will include a series of presentations and panel discussions on topics central to California's economic prospects – housing, infrastructure constraints, educational challenges, the environment, worker shortages, dramatic changes in demographics, technology, global trade, entrepreneurism, the booming entertainment industry, venture capital and biotechnology.

The conference will be held at the Los Angeles Marriott. More than 500 leaders in business and finance, public policy, academia and the media are expected to attend.

For complete program and speaker information, go to www.milkeninstitute.org, or call the Institute's conference line at 310-998-2605.

INSTITUTE RESEARCH PAPERS ON MINORITY BUSINESS CITED BY CALIFORNIA TREASURER

Philip Angelides, California's treasurer, announced an important new proposal to reduce the "widening disparity of economic opportunity" in California. Citing Milken Institute research in his report, *The Double Bottom Line: Investing in California's Emerging Markets*, the treasurer proposes policies to close a gap that "threatens our sustained suc-

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New Publications

• *Korea's Recovery: Don't Count on the Government*, by Hilton L. Root, finds that while government-directed reforms in South Korea have stalled in the past year, market forces are imposing many necessary changes in the country's financial, corporate and labor institutions.

• *Estimating the Cost of Opacity Using Sovereign Bond Spreads*, by Thomas Hall and Glenn Yago, shows that opacity and corruption raise the cost of capital to foreign borrowers by more than $500 billion a year.

Publications can be ordered through the Institute's Web site, www.milkeninstitute.org, or by e-mail (publications@milkeninstitute.org), phone (310-998-2600), or mail (The Milken Institute, Publications Department, 1250 Fourth Street, Santa Monica, CA 90401).

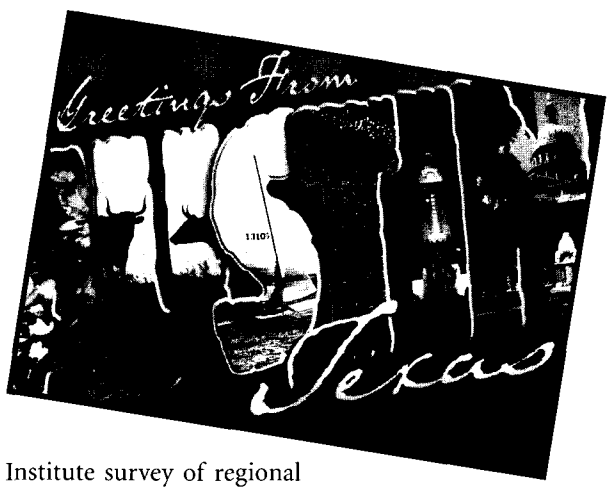
cess." In particular, it looks to ways to "mobilize the power of capital markets." According to Angelides, "California's economic and social strength will be diminished if the issue of inequality of economic opportunity goes unaddressed."

The Milken Institute and its Capital Studies group have worked closely with the treasurer and his office over the past 18 months in this effort to create new sources of capital for minority-owned businesses in particular. In his report, the treasurer cites the Institute's study, *Mainstreaming Minority Business*, which, he said, "has set the stage for public and private efforts to create secondary-market mechanisms for small-business lending to increase the flow of capital to underserved communities."

The treasurer's complete report and the Institute's research on emerging domestic markets are available on the Institute's Web site at www.milkeninstitute.org.

BEST PLACES FOR BUSINESS AND CAREERS

What city in America is the best for building a business or advancing your career? According to the second annual Forbes-Milken



Institute survey of regional economies, it's Austin, Tex. This year's ranking of "Best Places," published in *Forbes* magazine's May 20 issue, looks at two key factors to determine which metros are the most dynamic: jobs and earnings, and high-technology growth and output. The statistics were gathered by the Institute's Regional and Demographic Studies group, as part of its ongoing research into how high tech impacts regional economies. This is the second year the Institute and magazine have worked together on publishing the rankings. The other cities in the top five were: Atlanta; Santa Rosa, Calif.; Boulder, Colo.; and Boise City, Iowa. To view the complete rankings and stories, go to: www.forbes.com/tool/toolbox/bestplaces/00/index.htm.

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ASSETS UPWARDS OF 50 MILLION DON'T STOP WALL STREET HIGH-ROLLER CRAIG KORINARI FROM JOLTING AWAKE AT 3 A.M. NIGHT AFTER NIGHT
WHAT'S WRONG, HONEY?
I HAD THAT DREAM AGAIN!
THE SAME ONE? ABOUT THE CONVENIENCE STORE WORKERS?
YES, THAT ONE. THE NIGHTMARE!
TRY TO RELAX. IT PROBABLY WON'T COME TRUE...
BUT WHAT IF IT DOES?! WHAT IF IT DOES?!
TWO HOURS LATER, CONVENIENCE STORE WORKER SUSIE SCRIMP WAKES AND DRESSES QUIETLY SO AS NOT TO DISTURB HER THREE ROOMMATES.
SHE EXITS HER FRONT DOOR AND HEADS OFF TO WORK, UNAWARE SHE'S BEING FOLLOWED COVERTLY BY SAM SLY, DETECTIVE FOR EKONOTRAK, AN ECONOMIC SURVEY FIRM.
THIS IS THE DAY WALL STREET IS WORRIED ABOUT. WILL SHE DO IT?
SAM FOLLOWS HER INTO THE STORE AND PRETENDS TO SHOP FOR TOILETRIES.
HE HEARS SUSIE TALKING TO HER BOSS.
POP
I'M GIVING NOTICE. I CAN'T GET BY ON 6 DOLLARS AN HOUR ANY LONGER.
O.K. I'LL RAISE YOU TO $6.25. IT'S SO HARD TO GET GOOD WORKERS THESE DAYS.
BUT SUSIE CHOOSES TO PUT GREATER STRAIN ON THE U.S. ECONOMY.
$6.50 OR I WALK.
O.K. $6.50
SAM CALLS IN THE NEWS. EKONOTRAK ISSUES ITS REPORT.
SO
FINANCIAL NETWORKS SPREAD THE GRIM OMEN.
CONVENIENCE STORE WORKERS NOW GET $6.50 AN HOUR, SETTING OFF INFLATION FEARS THAT MIGHT CAUSE THE FED TO RAISE INTEREST RATES.
OH, NO! IT'S HAPPENED! I COULD LOSE POTENTIAL MILLIONS!!
THAT WEEK SUSIE SCRIMP BUYS A FEW MORE GROCERIES.
CRAIG KORINARI CAN'T SLEEP AT ALL.
HOW CAN SHE DO THIS TO THE ECONOMY?!
I KNOW, DEAR, I KNOW. IT'S NOT FAIR.

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MILKEN INSTITUTE

CALIFORNIA 2000 STATE OF THE STATE CONFERENCE

WEDNESDAY, OCTOBER 18, 2000

LOS ANGELES MARRIOTT DOWNTOWN

8:00 AM - 5:00 PM

California has overcome the downturn of the early 1990s to become one of the biggest success stories in the nation. But how long will it last? What challenges does the state face in the years ahead if it is to maintain its economic momentum?

This conference will address the key opportunities and challenges facing policy makers, businesses and citizens in the near and long-term future. It is an event for anyone doing business in California, or who has interests in the state and its future.

ISSUES TO BE DISCUSSED:

- A California Dilemma: More New Jobs than New Housing Units
- Balancing Economic Development and Urban Sprawl
- The Promise of Emerging Domestic Markets in Our Own Backyard
- Redevelopment and Urban Infill Opportunities
- Infrastructure and Limits to Economic Growth
- California's Trade Connection: Asia and Mexico
- K-12 Education Reforms and Technology-based Learning
- The Wave of New California Immigrants
- Knowledge-Worker Shortages and H1B Visas
- Entertainment and the New "New Media" California's Future
- Venture Capital and Tech Startups: Keys to Entrepreneurial-led Growth
- Biotech and Bioscience: California's Position at the Starting Line

KEYNOTE SPEAKER: Robert Parry, President, Federal Reserve Bank of San Francisco

PARTICIPANTS: Chairman Michael Milken; Cal Tech President David Baltimore; Amgen Chairman Gordon Binder; Oakland Mayor Jerry Brown; California State Treasurer Philip Angelides; Kaufman & Broad Home Corporation CEO Bruce Karatz; Entertainment Ventures Managing Director Sanford R. Climan; ***and many more.***

REGISTRATION INFORMATION:

Registration is $495, which includes meals and a comprehensive economic and demographic guide to California. Reservations are required. The deadline for registering is **October 6, 2000.**

The complete conference program and registration information is available online at www.milkeninstitute.org, or you may contact the Milken Institute by phone at (310) 998-2605, or by e-mail at conferences@milkeninstitute.org.

Corporate sponsorships are available by calling (310) 998-2632.

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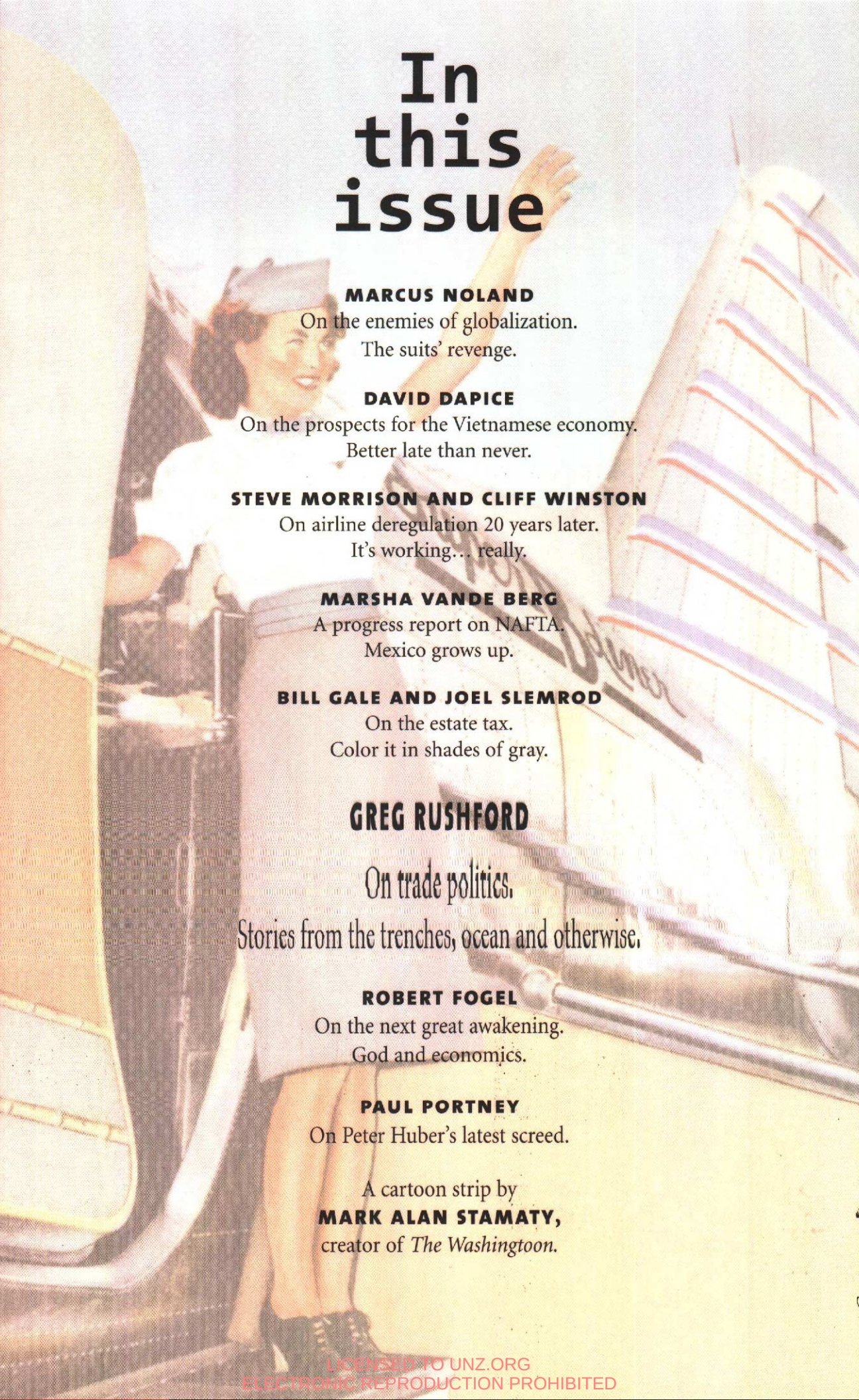

MARCUS NOLAND
On the enemies of globalization.
The suits' revenge.

DAVID DAPICE
On the prospects for the Vietnamese economy.
Better late than never.

STEVE MORRISON AND CLIFF WINSTON
On airline deregulation 20 years later.
It's working… really.

MARSHA VANDE BERG
A progress report on NAFTA.
Mexico grows up.

BILL GALE AND JOEL SLEMROD
On the estate tax.
Color it in shades of gray.

GREG RUSHFORD
On trade politics.
Stories from the trenches, ocean and otherwise.

ROBERT FOGEL
On the next great awakening.
God and economics.

PAUL PORTNEY
On Peter Huber's latest screed.

A cartoon strip by
MARK ALAN STAMATY,
creator of *The Washingtoon.*

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